CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS—PART II

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND FINANCE

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, AUGUST 2, 1995

Printed for the use of the Committee on Small Business

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CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS——PART II

WEDNESDAY, AUGUST 2, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAXATION AND FINANCE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:06 p.m., in room 2359–A, Rayburn House Office Building, the Honorable Linda Smith (chairwoman of the subcommittee) presiding.

Chairwoman SMITH. Thank you for coming. I want to welcome you to the Small Business Committee and, first of all, welcome our witnesses.

This is the second hearing of a two-part hearing. We had part of it last week. The business community, small business community and business groups came and testified about their needs. Today, we're going to ask that the Internal Revenue Service and the U.S. General Accounting Office come and respond and talk about what they feel we should do with independent contractor status, as a beginning. Then we'll go to other testimony right after that, and we'll introduce those folks that are going to testify then.

This subcommittee responded and will be working with other committees, but we will be drafting some of the language, making recommendations, legislative recommendations to clarify the status of independent contractors.

I have come to the conclusion there needs to be a legislative remedy, although I've read the testimony some of you and the Internal Revenue, have submitted and it hasn't been necessarily recommended, but I would like to state that that is probably not a question at this point. I am looking at a legislative remedy, and the subcommittee has been looking at that.

[Chairwoman Smith's statement may be found in the appendix.]

Chairwoman SMITH. But with that, we'd like to go directly to testimony. There are about a dozen mark-ups and floor action right now on one of the testiest bills we've had all year, so Members will come and go and we're going to proceed. There's never another day to put a hearing off to. So, we'll go ahead and start the subcommittee hearing and start with Mary Oppenheimer, who is from Internal Revenue Service. Excuse me, Mary, that's right. She said you were counsel, with Marshall Washburn. I'm getting your names mixed up already. You're here to be back-up for Mr. Washburn.

OK, Marshall Washburn of the Internal Revenue Service?

TESTIMONY OF MARSHALL V. WASHBURN, NATIONAL DIRECTOR OF SPECIALTY TAXES, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MARY OPPENHEIMER, ASSISTANT CHIEF COUNSEL, EMPLOYEE BENEFITS AND EXEMPT ORGANIZATIONS

Mr. WASHBURN. Thank you, Madam Chairman and members of the subcommittee. I'm pleased to represent Commissioner Richardson and to testify on behalf of the Internal Revenue Service on the administration of employment taxes.

During the course of my testimony today I will be announcing two important changes to the employment tax program relative to the issue of worker classification. I'm accompanied by Mary Oppenheimer, who is an Assistant Branch Chief in Employee Benefits and Exempt Organizations, and Chief Counsel.

The IRS has been working to improve tax administration for all taxpayers, including those who are small business owners. In March 1994, Commissioner Richardson established the Small Business Affairs Office to work with small business owners to address issues crossing industry and Government agency lines. The Commissioner has appointed Barbara Jenkins to head up this office.

Within the last several months, Commissioner Richardson, accompanied by other IRS representatives, conducted a series of six town meetings with small business owners across the country. Small business participants made numerous thoughtful suggestions for improvement at these meetings that the IRS is currently reviewing.

The Commissioner also participated in the White House Conference on Small Business. At this conference, the participants identified worker classification as their number one concern. Worker classification is also a significant issue in the Internal Revenue Service's administration of employment taxes.

Under the Internal Revenue Code, whether a worker is an employee or an independent contractor is determined using the common law standard. This standard looks to whether a business has the right to direct and control the means and details of a worker's activity. Applying this standard has been difficult for both taxpayers and for our agents.

Many years ago, to help our agents in this task, we developed training materials that listed factors that courts have used. These are the so-called 20 common law factors. They were designed as a checklist for agents to use in identifying which factors might be relevant as evidence of the right to direct and control in specific cases.

I would like to emphasize that the 20 factors do not answer the question of whether a worker in any specific business situation is an employee or an independent contractor. To do so, the business person or our examiner must first determine what factors are relevant to the business at issue. Then they must determine which factors are most important, and finally, they must consider whether other factors might be relevant.

Obviously, this lack of a clear and objective standard causes problems, both for small businesses and for our examiners, as well.

Section 530 of the Revenue Act of 1978 must also be applied by our examiners. This section provides taxpayers with relief from reclassification if they have provided required forms 1099, have treat-

ed a class of workers as independent contractors on a consistent basis, and relied on some reasonable basis for not treating the workers as employees.

In addition, Section 530 precludes the service from issuing regulations and published rulings about worker classification.

Over the last several months, we have been working to identify actions that we can take administratively to address concerns in the small business community about worker classification issues. Madam Chairman, today I would like to describe two important initiatives in the employment tax area announced by Commissioner Richardson that have resulted from this review.

We have heard concerns from the small business community regarding inconsistent and incorrect application of worker classification standards by IRS examiners. To address this concern, effective immediately, the IRS National Office will review and approve all proposed local compliance projects involving worker classification issues in a market segment or a geographical area. This includes projects where the issue is the existence of an employer-employee relationship, as well as those where the issue is the identity of the employer; for example, employee leasing.

We are taking this action because these projects often involve an entire industry, and we want to ensure uniform treatment of all affected taxpayers.

These projects may also involve difficult technical issues, the resolution of which may require input from national office staff. This review will also ensure that any proposed project involving worker classification will focus on serious deficiencies, such as the lack of information reporting or failure to pay overwithheld trust fund taxes.

In addition, National Office approval will ensure that project members seek input from business people in the affected industry and that all project members have been trained in the fair and impartial application of the existing statutory scheme of worker classification.

The IRS has also received criticism that some examiners do not approach worker classification issues in a fair and consistent manner and do not properly apply Section 530 of the Revenue Act of 1978. To address this concern, by January 1996, all IRS examiners handling worker classification cases will receive additional training. The training will reinforce the IRS's long-held position that using independent contractors can be a legitimate business practice that will not be challenged by the Service.

As part of the training, examiners will get experience through case studies of how the common law test of right to direct and control the means and details of a worker's services should be applied. The training will also emphasize the need by examiners to actively consider and liberally construe the worker classification relief provisions in Section 530.

To ensure that our materials will adequately and effectively train our examiners on worker classification issues, a draft of the training material will be shared for review and comment by the private sector, including small business, before the training is instituted.

We've already reexamined our approach to employment tax administration, looking for new and innovative strategies to increase

compliance within the existing statutory framework. I would like to take this opportunity to review for the subcommittee some of the steps we have recently taken to improve our efforts in this area.

At the national level, about 18 months ago, the IRS created the Office of Employment Tax Administration and Compliance under the National Director for Specialty Taxes. This office pulls together staff from the offices of Examination, Collection and Employee Plans and Exempt Organizations to improve the coordination and focus of employment tax issues. The office develops and oversees all employment tax compliance programs, including the employment tax examination program.

The subcommittee has asked us to supply statistical information concerning worker reclassification. Unfortunately, the IRS's current information systems do not enable us to track compliance results by issue. Thus, we cannot currently provide the subcommittee with data on assessments and collections resulting from compliance activities where worker reclassification or liability for self-employment tax was an issue.

The IRS is in the process of modernizing our tax systems and Tax Systems Modernization (TSM) is a massive undertaking that will take several years to implement. But one of its benefits will be the ability to track compliance results by issue. We would welcome the support for TSM by this subcommittee.

Along with the training program discussed above, the IRS is also ensuring the consistent treatment of similarly situated taxpayers by consolidating the processing of Forms SS8 at two sites. Currently one of the ways taxpayers resolve doubts about worker status is to request a private ruling from the IRS using form SS8. In the past, these SS8s were processed by our districts throughout the country. We're in the process of consolidating this into two sites, which should improve the consistency with which we make those determinations.

The Market Segment Understanding (MSU) program is a new and innovative approach to resolving some longstanding disagreements with various industries. MSU's offer the IRS and industry a tool to resolve worker classification issues. An MSU focuses on a particular area of noncompliance where the facts or application of the law is unclear, or where noncompliance is widespread within an identified market segment.

The MSU process is unique because it uses a working group of both IRS and industry representatives to discuss and reach mutual understandings of the facts characteristic of the industry and how the law applies to those facts.

The desired outcome of the MSU process is the issuance of a guideline document that provides clarification of the issue or a pro forma accord. MSU guidelines are helpful to examiners, as well as taxpayers and their representatives.

The first MSU completed under the program addressed the classification of workers in the television commercial production and professional video communications industry.

On June 1 of this year, members and representatives of the food service industry and the IRS entered into an agreement known as the Tip Reporting Alternative Commitment, TRAC, to increase the compliance of tipped employees in the food and beverage industry.

TRAC is a pro forma agreement entered into on an individual basis by food and beverage employers. So far, approximately 3,000 establishments have signed on to TRAC. As a result of TRAC, IRS expects the amount of tip income reported annually to increase from between $3 to $5 billion.

Other projects that the IRS is pursuing regarding worker classification include physical therapists, limousine drivers, truckers, movers, home delivery service, and drywall contractors.

As part of its overall goal of helping small businesses, the Internal Revenue Service is taking steps to ensure that worker classification projects are properly focused and that our examiners are thoroughly trained in the correct application of the common law standard and Section 530 of the Revenue Act of 1978.

This concludes my prepared statement, Madam Chairman. We'd be happy to answer any questions.

[Mr. Washburn's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. We will go to Mr. Gandhi, and Mr. Short, you're supporting him. Thank you. Mr. Gandhi of the—actually, I always want to say GAU, which is our State general administration, but you have a different initial, the GAO.

Mr. GANDHI. General Accounting Office.

Chairwoman SMITH. Yes, thank you. Please begin.

TESTIMONY OF NATWAR M. GANDHI, ASSOCIATE DIRECTOR FOR TAX POLICY AND ADMINISTRATION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY THOMAS D. SHORT

Mr. GANDHI. Madam Chairman and members of the subcommittee, we are pleased to be here today to assist the subcommittee in its inquiry into the misclassification of workers for Federal tax purposes.

Ensuring appropriate classification has been of long-standing interest to GAO and we have been testifying before this and other congressional committees and have issued several reports on the subject matter through the years.

Using our past work as a basis, I would like to make four observations this afternoon. First, we believe now, as we did in 1977, that the rules for classifying workers need to be clarified. Until they are, we are not optimistic that the widespread confusion over who is an independent contractor and who is an employee can be avoided.

IRS has adopted 20 common law rules to help classify workers, and they remain as unclear and confusing as we found them in 1977.

The misclassification of employees has, in the past, cut across all industries and has involved up to almost 20 percent of the employers in some industries.

Even the Treasury Department concedes that applying the common law test in employment tax issues does not yield clear, consistent or satisfactory answers, and reasonable persons may differ as to the correct classifications. Yet no final action has been taken to clarify the rules.

To make the classification decision more certain, we proposed a rather straightforward test in 1977. We proposed then that the Internal Revenue's Code may be amended to exclude workers from

the common law definition of employee in those instances where first, they have a separate set of books and records which reflect items of income and expenses; second, they have the risk of suffering a loss and opportunity of making a profit; third, they have their own separate principal place of business; and fourth, they hold themselves out in their own name as self-employed and/or make their services generally available to the public.

We also recognize that there may be some situations where a worker is able to meet some but not all of the above criteria and still have a valid basis for being considered self-employed. In such cases, common law rules would apply.

Now to my second observation. While recognizing this ambiguity, IRS is responsible, as the Nation's tax administrator, to enforce tax laws and rules. Since 1988, IRS's employment tax examination program has completed 11,380 audits resulting in IRS proposing tax assessments of some $751 million and reclassifying about 483,000 independent contractors to employee status.

My third observation is that in addition to rule classification and compliance audits, there are two approaches that could help improve independent contractor compliance. One, require businesses to withhold taxes from payments to independent contractors; and two, improve business compliance with the requirements to file information returns on payments to independent contractors.

IRS data for tax year 1992 suggests that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 to $30 billion of the individual income tax gap. The two approaches should help improve tax compliance, rather than to rely upon reclassification and retroactive tax assessments provided for in the law.

Finally, Madam Chairman, my fourth observation. Aside from tax issues, changes to the classification rules need to be cognizant of the large body of laws that create a safety net for American workers. Many laws apply only to employees. They do not protect workers classified as independent contractors.

For example, unemployment insurance is nearly universal, covering over 90 percent of the American workers. This 60-year-old program provides short-term financial support for covered workers who, through no fault of their own, become unemployed. It also helps the unemployed from having to turn to public assistance programs. In times of economic downturns, the payments made to the unemployed may take on added significance.

However, Federal law does not require coverage of independent contractors for unemployment insurance, although one state—that is California—has provisions that would allow independent contractors to apply for self-coverage.

Because a by-product of rule clarification is the potential for treating more workers as independent contractors, we believe the current deliberations should also focus on potential impact on the social safety net established for American workers.

That concludes my statement, Madam Chairman. I request that my full statement be made part of the record. I'll be pleased to answer any question that you or other members of the subcommittee may have. Thank you.

[Mr. Gandhi's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. I appreciate your statement. It was very easy to follow and made a lot of sense.

I'm going to start with one brief question, and then let Mr. Meehan, who's now joined us, come in as the chair with his opening statement, and also he can begin questioning. Then we'll move to Mr. Bartlett and Mr. Baldacci right after that.

First of all, I guess I want to ask a question, Mr. Gandhi, that's pretty general. You mentioned that you believe that one of the great questions we have to ask in this, and it might be the seed to why the audits are going the way they are, is that we have to socially—and you didn't quite say this, but you did—push people into a safety net situation, because if they're independent, which independence takes risk, they might need to have services.

So would you then say that we should audit with that in mind or would you recommend that it be a law change with that in mind? Or what are you saying there?

Mr. GANDHI. Well, we are suggesting that Congress ought to keep that consideration in mind because we have spent some 50, 60 years building up that social safety net. If there were not a proper consideration given to this probable fact, then perhaps there may be other ways in which we would have to provide for people who were not really careful to provide for buying these benefits on their own.

Chairwoman SMITH. I read all of your information earlier. So, the compliance issue, to you, pushing for compliance might be good for two reasons. You somehow get these people who are the mom and pop out there surviving with two kids, you force them into the safety net. Even though they wanted to be independent, you say you can't. You collect some money and you get them into compliance with the law.

Mr. GANDHI. No, I wouldn't want to force anybody into anything. The issue that we want to keep in mind here is that we have been able to build a safety net over the years, and if we were to think in terms of having changes in the common law or in the tax code, that would mean there would be more or less independent contractors, so then we want to keep this consideration in mind.

Chairwoman SMITH. OK. With that, Mr. Meehan, welcome.

Mr. MEEHAN. Welcome. First I would like to thank the Chair, Mrs. Smith, for holding continued hearings on the independent contractor tax.

Last week we heard from several representatives of the small business community on the status of independent contractors, and I think they all agreed that the 20-factor test used by the IRS to determine compliance is too subjective. While some of the witnesses felt comfortable with the changes made in Representative Christiansen's bill, others felt that the Congress needed to go further and eliminate the 20-factor test altogether. I hope today's hearing will further clarify the relevance of the 20-factor test.

As I mentioned last week, I support the changes proposed in the White House Conference on Small Business. The conferees' recommendations are crafted to ensure that the industry quirks do not preclude a specific small business from claiming independent contractor status.

I welcome the comments from Mr. Washburn on the compliance issues today. I'm interested, and I guess the long and the short of it is is this a matter of further training by the examiners, or do we need a statute change? I guess that's where the inquiry is, and any comments on that would be appreciated.

Mr. WASHBURN. Congressman, the IRS has taken the position that the best solution to the ambiguities in this whole issue would be a legislative solution. However, when it comes to what the best legislative solution is, that's not IRS's role. We defer to the Department of Treasury on that.

But we do believe that a solution that includes some sort of simplified definition and involves information reporting would be desirable.

Mr. MEEHAN. Thank you. I have no further questions.

Chairwoman SMITH. Mr. Bartlett.

Mr. BARTLETT. Thank you very much. I appreciate having this meeting. In a former life I was a businessman and hired people and hired independent contractors. I was in land development and homebuilding, and these are two of the areas where you probably run most frequently into problems with who is an independent contractor and who is not an independent contractor.

I was intrigued that you listed drywall contractors as an area in which you would try to decide whether they were independent contractors or not. Isn't that kind of a contradiction in terms here? If they're a drywall contractor, aren't they, by definition, an independent contractor and not an employee?

Mr. WASHBURN. What that really refers to, Congressman, is we are actually working with representatives from the industry and from labor in that industry to see if we can't mutually agree and come to an understanding of what workers in that industry would be properly considered employees and which ones would be considered independent contractors under the current statutory scheme.

Mr. BARTLETT. I'm having trouble understanding why that should consume much time. If you pay them by the hour, I would think they're a contractor. If you pay them by the piece, they get so much per 4-by-8 for hanging it, so much for taping it, so much for blocking it, so much for finishing it—if they're getting paid that way, aren't they, by definition, independent contractors?

Ms. OPPENHEIMER. The drywall contractors approached the Internal Revenue Service, asking that a project be established to work through what the relevant factors would be. Method of payment can, of course, be one very relevant factor in that situation.

The industry has clearly felt that it would be beneficial to have some clarification on that, and that's what we're trying to do with them.

Mr. BARTLETT. What is the intent of the industry? What do they want you to find?

Ms. OPPENHEIMER. They want to have a clear and objective method for determining, when they hire a worker, whether they should be treating that worker as an employee or an independent contractor.

Mr. BARTLETT. I think that perhaps the drywall contractors are one of the easiest places to make this kind of a decision. If they come and work on hours that you prescribe, use your tools, and you

pay them by the hour, rather than by the job, they are quite clearly, I think, employees.

If they come using their tools, working hours of their choice, getting paid by the piece, is there any argument that they're not independent contractors? I don't understand why this should take more than the time we've spent discussing it to decide whether they are independent contractors or employees.

Ms. OPPENHEIMER. Well, when we see the project that they propose to us, maybe we will be able to judge that better. We have not yet seen the work that they're doing in that area.

Mr. BARTLETT. Oh, OK. I have a question here relative to—in recent years, IRS has taken the position that when an employer under Section 530, which I understand you can use industry practice and your history of practice and so forth to determine that workers that you have in a certain category have been treated as independent contractors, the IRS will give you safe haven there, to agree that yes, you can continue to include them as independent contractors.

But I gather that some employers feel that the only way they can come there is to agree that all of their workers are, in fact, employees. I don't understand how it's a safe haven if, when you come to ask for Section 530 consideration, that you have to agree that all of your workers are employees. Where is the safe haven if you have to agree to that?

Ms. OPPENHEIMER. Section 530 does not require a concession by the employer. When you look at Section 530, it does state that it applies to employees. We have, however, clarified to the field that an employer can say, "Even if I disagree with you about whether these people are employees, let us look at Section 530."

Indeed, we have instructed our examiners that they should look at 530 on their own initiative.

Mr. BARTLETT. Let me ask a question. If we had, instead of our present tax system, if we had a consumption tax, do we need then to have meetings like this and to discuss this at all, or do all of these problems go away?

Mr. WASHBURN. Congressman, I really can't respond to that. I think there are a lot of different options on the table. But again, the only thing I would caution is there's no simple solution to this issue or this problem, but I can't really respond to the benefits of a consumption tax.

Mr. BARTLETT. Let me ask a general question. What is Treasury's concern regarding whether a worker is an employee or an independent contractor?

Mr. WASHBURN. What our concern is, first of all, we have no—we don't really care whether businesses use employees or independent contractors. I know we're accused of having a bias against independent contractors, but that is not our policy.

What happens is that the law forces us into being involved in the determination of whether a worker is an employee or an independent contractor because——

Mr. BARTLETT. Why do you think the law is there, then? If all you're doing is——

Mr. WASHBURN. The distinction is who's going to pay the employment tax? Is it going to be the employer, the service recipient, or

is it going to be the service provider? That's what the law is intended to define, is who's an employee and who's an independent contractor.

Mr. BARTLETT. Why should that not be an agreement between the worker and the employer? Why do we need Government involved in that determination?

Mr. WASHBURN. Perhaps it could, but that's not the way the existing statute is.

Mr. BARTLETT. Would you like the statute changed so you didn't have these problems?

Mr. WASHBURN. Well now, that's a policy issue again, you see, and I can't comment.

Mr. BARTLETT. Which was my first question. I was asking what your policy was, and you deferred to law.

Ms. OPPENHEIMER. The Treasury Department takes positions on issues of tax policy.

Mr. BARTLETT. The interest here is what? I'm having trouble understanding what the interest is.

Ms. OPPENHEIMER. We would be happy to comment on issues of tax administration, but we cannot. The Treasury Department would need to comment on basic issues of tax policy such as you've raised.

Mr. BARTLETT. OK. So, you're here just to comment on the problems of implementing the law? You're not here to talk about whether you agree with the law or not?

Mr. WASHBURN. That's correct. We can talk about the problems of administering the law and the confusion that evolves around the issue of employee-independent contractors. Obviously, there are two sides to that coin and we hear from both sides. We hear it from people who are concerned that we're overzealous and trying to reclassify workers as employees, but we also hear from people on the other side who feel that there's an uneven playing field and that the IRS is not doing enough.

What we believe is that under the current law, we are required to make—we have to get involved in making that decision.

Mr. BARTLETT. If I have another moment, Madam Chairman, does the Treasury collect more taxes from one designation than the other?

Mr. WASHBURN. Studies that we've had in the past show that if everything were equal, if everybody is complying fully with the law, we don't have any reason to believe that people being employees or independent contractors, one way or the other, would produce more money. But of course that's on the assumption that everybody is complying with the law.

In other words, the law itself is probably revenue-neutral in terms of whether people are employees or independent contractors.

Mr. BARTLETT. If 1099's are conscientiously submitted, wouldn't that give a paper trail so that one could be reasonably sure that equivalent taxes were going to be collected from the two categories?

Mr. WASHBURN. Right. Studies we've done in the past indicate that where misclassified employees receive information reports, they report their income about 88 percent of the time. If they don't receive 1099s, they report it about 29 percent of the time. Of

course, both those numbers compare with employees, who get W2s, of 99.8 percent.

Mr. BARTLETT. So, what we need is a mechanism for making sure that there's better accountability.

Mr. WASHBURN. Like I've said, our experience is that information reporting does improve compliance.

Mr. BARTLETT. Thank you very much.

Chairwoman SMITH. I would like to follow up, with the consent of the subcommittee members, with just one question on compliance, because the question seems to fit right here.

I've been looking at compliance and trying to figure out who's right. You show that you think the compliance is around 30, 40 percent, and that was represented in some earlier testimony, in some things I have read from you.

The GAO has reported that there's only about a 3 percent difference between W2 compliance and independent contractor compliance when forms 1099 are filed, and only about a 14 percent difference when forms 1099 are not filed.

Can you give me any idea—I guess I'll ask Mr. Washburn of the Internal Revenue Service—give me some clarity on that. Then I want to ask you a question—I guess I'll just ask it at the same time—about your formula because it looks like you include what I consider the underground economy—you call it the informal supplier economy—when you show how much revenue loss, what the billion dollar gap is.

You say $2 billion of the $30 billion tax gap is from independent contractors, and I guess what I'm trying to figure out is how the informal supplier fits into that and how much of your equation that represents.

Mr. WASHBURN. I'm sorry, Madam Chairman. I don't have the tables right in front of me. But when we talk about the tax gap, sometimes we're talking about the tax gap that includes employment tax and income taxes and that sort of thing. Other times we may be talking strictly about the employment tax gap, just the employment tax itself. Then there are other times when we may be referring to the gap strictly from misclassification.

For example, you mentioned information reporting accuracy. W–2 filers, of course, people who receive W2s, are the most compliant in terms of the percentage of their income that they report, at 99.8. Just below that, I think three points or something like that, are people who receive—not misclassified employees, but just people in general who receive 1099s. Their compliance level is—I think it's around 97, something in that range, 97.4.

What happens then, when you start zeroing in on misclassified workers, there's a drop. That's where you come down to 77.2 percent compliance on misclassified workers, who receive 1099s but they just aren't as compliant as the general public who receives the 1099s.

Then it drops down to 29 percent if the misclassified worker doesn't receive any information report.

Chairwoman SMITH. But you don't know if that person actually pays their own taxes. You just say they're misclassified.

Mr. WASHBURN. No, our study was actually doing an audit of somebody who was misclassified. In other words, we concluded that

they were an employee who had been misclassified as an independent contractor, had not received either a W2 or 1099 or anything like that. Our statistical audit study showed that in 1984—that was when the study was done—that they only reported 29 percent of their income.

Chairwoman SMITH. So, we might be talking about marginal people who are surviving, not necessarily the affluent in society but maybe mom and pops or a mom that has one child, going into a home, babysitting for another child and doing it in a way that she's surviving, not trying to avoid taxes, but just barely holding onto life. That is a part of that.

Mr. WASHBURN. We certainly would not include anybody in there who didn't have a tax liability.

Chairwoman SMITH. She would be liable for her Social Security, though. You're talking about compliance for self-employment. Certainly she would be——

Mr. WASHBURN. This study, Madam Chairman, was small businesses, so we would not have babysitters and domestics and that sort of thing in that study. I don't know how small they were, but they were small.

Chairwoman SMITH. I guess I need to know what the underground economy is because if you weigh in fairly, the informal supplier—that's not services, also?

Mr. WASHBURN. Perhaps what we could do is either provide you the information, get back to you with the specific information, or meet with you or something.

Chairwoman SMITH. Yes, that would be really good because a lot of what I'm reading indicates you're aggressively (about 90 percent) finding people to be employees at the national level, in your audits here. It looks like it's an aggressive effort, trying to identify people as employees.

You show a gap of lost tax revenue and we, as public servants, should be responsible to make sure everybody pays their tax. But I guess I want to see who those are. I think there's a certain portion of the economy that just is surviving and they're not bad people, and if you try to grab them, put them into something, make them pay more taxes, they're probably not going to be able to feed the kids.

So I need to see how it's made up, and I want to see how much those figures affect your tax gap and compliance numbers, who really is in that.

With that, I will take that in writing. I'd be glad to. Mr. Baldacci, we're going to be serving together for 2 years and I'm still messing up his name. Smith is so easy.

Mr. BALDACCI. My father said that back in Italy, Baldacci was like Smith and Jones.

Chairwoman SMITH. I'll get it straight.

Mr. BALDACCI. Thank you very much.

Chairwoman SMITH. Thank you for your patience.

Mr. BALDACCI. Well, thank you very much for holding these hearings and to be able to explore these issues. I do think that they need to be explored and we need to hear both sides. Being a small business person and having to deal with regulations, you sometimes get the approach that regulation is bad because they tell you

how the run their businesses, but I think if you approach it in a constructive manner, I think it can be beneficial to both, on both sides of the aisle.

So I appreciate these hearings and I appreciate the discussion that's going on, Madam Chairman, and would yield back the balance of my time to anybody who would like to ask any question.

Chairwoman SMITH. Are there any additional questions? I only have one. It's for the Internal Revenue Service, and I'll ask just one. That is, I was looking at Mr. Washburn's testimony, and as I was reading it I thought, "Yes, this is right. Finally they must consider whether other factors might be relevant, but obviously this lack of a clear and objective standard causes problems both for small business and for examiners, as well." And I thought, "boy, that could be testimony for all of us."

So I found it unfortunate that you couldn't make recommendations to fix it. I appreciate the fact that you do want to try to train—I guess I will tell you I'd love to see you train, and I used to help write training materials—I'd like to see you be able to train under clearer standards, easier to understand by everyone, and then we would know. We could actually train people in a way that we could trust.

Mr. WASHBURN. I can commit to you, Madam Chairman, that we recognize there's training and then there's training, and we intend to—that's why we're saying it'll take us until January to do it because we realize that it's not just a matter of rolling out some paper. We've got to come up with case studies and examples and that sort of thing, because it is such a complex area that we've got to do something different than we've done in the past to ensure that our people understand the rules.

Chairwoman SMITH. Thank you very much. Mr. Bentsen has joined us. You weren't privileged to the testimony, but if you have any questions of the panel, please go ahead.

Mr. BENTSEN. I appreciate the chair yielding and I don't have any questions at this time.

Chairwoman SMITH. Thank you all, and I'm interested in looking at your training. Thank you.

Thank you for your patience and we've changed the order a little bit, by the request of those testifying, and we'll start with Mr. James Pyles. Mr. Pyles is with Powers, Pyles, Sutter & Verville, on behalf of the Coalition for Fair Worker Classification. I welcome you and please begin.

TESTIMONY OF JAMES C. PYLES, COUNSEL, POWERS, PYLES, SUTTER & VERVILLE, ON BEHALF OF THE COALITION FOR FAIR WORKER CLASSIFICATION

Mr. PYLES. Thank you, Madam Chairwoman and members of the subcommittee. I'm James C. Pyles, counsel for the Home Health Services and Staffing Association. HHSSA, is a member of the Coalition for Fair Worker Classification, which includes representatives of associations of both large and small businesses, management and labor, who feel that legislation is needed to curb the intentional abuse of the independent contractor designation.

The coalition represents the businesses that take the trouble to determine how the employment tax laws apply to their activities

and to comply with the law. The coalition does not oppose the legitimate use of the independent contractor status, but is opposed to the pervasive and growing practice, documented in Congress many times, of some businesses to ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies.

Certainly the anecdotes of individuals who've been subjected to heavy penalties for misclassifying workers generate sympathy, but what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, and incur other overhead costs associated with the designation of workers as employees? And I've listed some of those in my testimony for you. Where do the concerns of these individuals and businesses get taken into account?

The sponsors of H.R. 1972 and 582, as well as the delegates to the White House Conference on Small Business, are to be congratulated for bringing the issue of fair worker classification to the forefront of the 104th Congress's agenda, but the solutions proposed in those bills fail to address the underlying problems and, in fact, will make those problems worse.

No one would dispute that the common law test which is required by statute to be used to distinguish between employees and independent contractors is based on a 20-factor test which is ambiguous and difficult to apply consistently. Enforcement of that law is made virtually impossible by Section 530 of the Revenue Act of 1978, which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee.

Accordingly, this hopelessly ambiguous area of the law has not been clarified because Section 530 prohibits it. I would repeat, the law has not been clarified because the law prohibits its clarification. There's been some ambiguity on that.

H.R. 1972 and 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal Section 530, but rather simply adds a definition of individuals who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although 1972 professes to be intended to clarify the existing law through the addition of objective standards, the criteria contained in the bill are vague and would be impossible to clarify.

For example, the bill would permit workers to be classified as independent contractors if they had a significant investment in assets or training, or had significant unreimbursed expenses, or agreed to perform the service for a particular amount of time. None of those key terms are defined, and with the prohibition on clarification in Section 530 unrepealed, no clarifying regulations could be issued.

Further, the criteria completely ignore the issue of control, which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors. For example, a worker could be classified as an independent contractor, even though the worker's every movement was controlled in every detail by the employer, if the worker paid for his or her

own education or had school loans. This would introduce a novel concept into the law, the totally dependent independent contractor.

Accordingly, the effect of H.R. 1972 would make the classification of most workers completely discretionary for most employers. In addition, 1972 does not incorporate a consistency principle, which appears even in Section 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today as independent contractors tomorrow and as employees again the next day.

This may be a hearing before the Small Business Committee, but this also is big business because 1972, for example, would allow big businesses to reclassify workers, as well.

H.R. 582 is a somewhat better piece of legislation in that it is less vague and repeals Section 530. We do not favor this legislation, however, because it incorporates the safe harbors of Section 530 into the Internal Revenue Code and retains the illogical and inequitable prior audit safe harbor.

Both bills suffer, however, from the serious problem that they are likely to cost the Government billions of dollars in lost tax revenue. We understand that H.R. 582 has already been scored by the Joint Committee on Taxation as costing nearly $600 million over 5 years, and that amount is likely to increase to $1 billion, at least, over the 7-year planning horizon used for budgeting purposes. We believe H.R. 1972 would be scored at a much higher cost.

A study performed by the accounting firm of Coopers and Lybrand last year concluded that misclassification of workers under the current law will cost the Government approximately $35 billion over the next 9 years. We've heard additional testimony from GAO about those figures this afternoon.

This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting $270 billion over 7 years from the Medicare program, on which many of our Nation's frail elderly depend.

At the very least, H.R. 1972 should be scored to determine the extent to which cuts would have to be made in other programs to fund the loss. Let's at least be honest with the American people and tell them what this cost will be and how Congress expects to pay for it.

Rather than legitimizing the abuse that has gone on in the past at the cost of billions of dollars of desperately needed tax revenue, we recommend a more moderate approach that still addresses the concerns identified by the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill, sponsored by Republican Congressman Christopher Shays and Democratic Congressman Tom Lantos. We believe that legitimizing the past abuse is really like legalizing drugs to prevent drug abuse.

Failing to adopt H.R. 510, if that is not a desirable approach, we would recommend the establishment of a commission comprised of individuals from a broad cross-section of the employer and worker communities to make recommendations to Congress on how this difficult issue can be resolved. We would be very happy to work with the subcommittee to try to arrive at a solution for this difficult problem.

I'd be glad to answer any questions the subcommittee might have.

[Mr. Pyles' statement may be found in the appendix.]

Chairwoman SMITH. Thank you. We'll hold the questions until all the panelists have spoken; then we'll come back to you, Mr. Pyles.

Mr. Shulman, thank you for coming. Mr. Shulman is with the National Association of Computer Consultant Businesses. I read your testimony; it's fascinating. Please begin.

TESTIMONY OF HARVEY J. SHULMAN, GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

Mr. SHULMAN. Thank you, Madam Chair. The National Association of Computer Consultant Businesses is the largest association exclusively representing companies who provide highly skilled, technical professionals on a contract basis to customers who need temporary project support. Our 235 member firms have over 500 offices, with combined annual revenues of over $2 billion.

Our member firms value the freedom of choice to establish either an independent contractor or employment relationship, guided by only marketplace forces and individual preferences. Yet our industry suffers the most under the stringent employment tax audits conducted by the IRS because of an experimental law, Section 1708 of the '86 Tax Return Act, which discriminatorily singled out only the technical services industry for loss of the so-called Section 530 safe haven, still enjoyed by every other industry in the United States.

My written testimony explains how the Section 1706 experiment has failed dramatically. In fact, the congressionally ordered Treasury study referred to earlier today actually shows that tax compliance in our industry is higher than average and that Section 1706 may, in fact, cause tax revenues to be lost when independent contractors are forced to become employees in our industry.

A strong bipartisan consensus has emerged to repeal Section 1706, and its repeal is basic to any independent contractor reforms.

However, my testimony today mainly focuses on the broader question of employment tax audits that affect all industries and all self-employed workers. As general counsel of NACCB and a partner in the Washington, DC law firm of Ginsburg, Feldman & Bress, I've been personally involved in over 40 recent IRS employment tax audits around the country. I have experienced the implementation of an audit process that too often, in my opinion, disgraces our tax system, subverts our economic system, deeply invades and intrudes into our lives, mocks our system of justice, and, to top it off, seriously harms American businesses, especially vulnerable small and mid-size businesses.

Preliminarily, I want to emphasize I don't believe there's a national IRS office conspiracy to eliminate independent contractors. Instead, the IRS claims it must enforce difficult employment tax standards. The vast majority of IRS field auditors are honest and well intentioned.

Unfortunately, however, rarely do we hear top IRS officials saying that all businesses, small, mid-size and large, can and do reap benefits from using the services of self-employed workers who are

entrepreneurs, work hard, contribute to our economy, pay their taxes, and are helping to develop a work force for the 21st Century.

Instead, the word "independent contractor" is often uttered only when accompanied by words like "tax cheat" and "unfair competition." In these circumstances, it's not surprising that even well intentioned IRS auditors view self-employed workers and businesses which use them as a disease that has to be cured.

Nor is it surprising that auditors see themselves as zealous prosecutors. As one IRS auditor said to me in words like these, "By the time we finish audits of the computer industry in this state, there won't be any more self-employed computer consultants left here." This is the type of thinking that's got to be stopped.

Congress needs to send a wake-up call to the bureaucrats. The IRS program announced earlier in this hearing may prove some help, but Congress can't wait.

Although the hearings so far have focussed on the substantive legal test used to classify workers as independents or employees, my testimony is primarily going to look at the IRS practices used in audits.

I note that our written testimony does support Mr. Christiansen's bill as providing a substantive test that can take us into the 21st Century. In particular, it accommodates not only blue collar workers but also the growing class of knowledge workers, like sole proprietor computer consultants and engineers, who hold themselves out as self-employed business people, despite engaging in longer-term projects and being paid, like lawyers, by the hour.

Likewise, we support greater compliance measures and much stiffer penalties for noncompliance. But penalties which force companies to convert independent contractors to employees are not the remedy.

In my oral testimony now, I'm going to look at the unfair practices the IRS uses, and I think you will agree that they're really practices that are just terribly hard to justify.

We need to revise the intrusive practices the IRS uses to conduct audits, regardless of whatever substantive standards it uses. Often I've been told by Government officials that even though other Federal agencies might not be able to engage in similar practices, an exception has to be made for the IRS because it collects taxes. We have to stop sanctifying the IRS.

A business undergoing a civil IRS investigation is entitled to no less procedural protections than a business being investigated by other agencies.

My written testimony provides many examples of unfair audit procedures, but I'll only mention three here.

First, did you know that as soon as an IRS appeals officer upholds a field auditor's recommendation to reclassify a business's independent contractors as employees, that the IRS immediately imposes a tax assessment and lien against the business, even before the business has its day in court in front of an impartial judge? These assessments typically cause creditors, like banks, to cut off lines of credit and loans.

A court might eventually rule that the IRS acted wrongly in reclassifying workers, and no taxes are owed, but the business may

be out of business because of the assessment and the lien. Guilty and executed before trial.

We need to change the Internal Revenue Code so that unless there is fraud or similar misconduct, businesses in employment tax audits have a right to a court trial before any assessment and a lien, just like businesses in other audits.

May I continue for another minute?

Chairwoman SMITH. Would you please? Complete your testimony.

Mr. SHULMAN. Thank you, Madam Chair.

Second, did you also know, Madam Chair, that if you are a business under audit for using independent contractors, then IRS auditors will typically track down and interview the contractors themselves and even contact your biggest customers to ask them about the work performed by those contractors that you hired?

By being interviewed and asked for extensive documentation, many self-employed workers and customers no longer want to do any business with a business that's under an IRS audit. I'd like to leave for the record—I brought an exhibit—a letter that an IRS auditor sent to independent contractors of a business. These contractors were not being audited, but the letter asks them to provide, for purposes of the audit of the business, copies of all of their checks, all of their letterhead, all of their business insurance, all of their Schedule C's, all of their clients, all of their suppliers, all of their billings, all of their workers comp policies, all of their licensing agreements, all of their permits, all of their telephone bills, and on and on and on.

This is a letter sent to an independent contractor who wasn't even being audited, but worked for a business that was being audited.

As one auditor told me when we were discussing my concern about her plans to contact my client's customers, she said, "That's what we call life in the audit lane in this office. That's your problem, not ours." Congress cannot let that kind of practice continue.

Finally, did you know that if you're a business under audit for using independent contractors, that IRS auditors often use their computers to retrieve private income tax information from the contractor's own tax returns, and then they use that information against your business by saying that the information they secretly got supports their decision to reclassify those contractors as your employees?

For example, the IRS will say to you, "Sally Smith and the 10 other contractors you had are not really independent contractors because their Schedule C expenses are too low," whatever that means. Yet by basing its conclusion on the secret facts and withholding them from you, the IRS has left you with no fair chance to rebut these assertions.

As one auditor said to me, "I understand how it seems unfair but that's just the way it's done." Congress has got to stop that from happening.

Madam Chair, thank you for listening. There are many more problems mentioned in my written testimony that I hope you will address. We do need to improve tax reporting. We do need to improve the substantive test for determining who is and isn't an inde-

pendent contractor. But we can do all of that, and unless you tackle the audit procedures that are being used to smother businesses in this country, we're going to get nowhere. Thank you very much.

[Mr. Shulman's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. We will be submitting a written letter to IRS on this particular testimony, about some of the particulars, asking for the authority that they have to do certain things and what particular laws authorize what they're doing, and also looking at changing the law to be consistent. You should never be guilty until you're—you shouldn't have a lien. That is an action that's a pretty serious action of not just implied guilt, but guilt, before you actually are shown to be deficient.

Mr. Wolyn, thank you for your patience. That was an extended testimony but certainly if you're a little bit longer we'll give you a chance to complete yours. Mr. Wolyn is from the Bureau of Wholesale Sales Representatives, and please proceed.

TESTIMONY OF MICHAEL A. WOLYN, EXECUTIVE DIRECTOR, BUREAU OF WHOLESALE SALES REPRESENTATIVES

Mr. WOLYN. Thank you, Madam Chairwoman, members of the subcommittee, my name is Michael Wolyn and I'm executive director of the Bureau of Wholesale Sales Representatives, a national organization of 7,000 independent apparel and footwear sales representatives. I also speak today on behalf of 3,500 members of the International Home Furnishings Representatives Association.

The issue of worker classification is near and dear to our hearts and I want to commend and thank the subcommittee for addressing it. I can discuss some specific reclassification cases with the subcommittee, upon request, but for purposes of my testimony, I'm going to focus mainly on the language of H.R. 1972 and H.R. 582.

Each bill would achieve the important goal of clarifying the relationship between manufacturer and sales representative. Going beyond the 20-factor test currently used by IRS to determine classification is a great step forward that will eliminate the confusion that occurs on behalf of manufacturers who make use of independent reps.

The 20-factor test is far too arbitrary and, in many cases, has been utilized to reclassify sales representatives, despite the fact that they work on behalf of several different manufacturers, set their own work schedules, have substantial investments in business equipment, and are paid primarily by commission.

It is reasonable to expect a principal to offer some degree of input into the methods a sales representative employs to promote its lines of merchandise, but these marginal levels of input should not be construed to constitute a significant level of control over that sales rep. Under current law, that is sometimes the case.

Again, the definitions of an independent contractor, under either of the bills in question, would be a far more effective test.

The greatest concern of the 10,000 independent business persons I represent is in the protection and fortification of the safe harbor protections currently found in Section 530. Sales representatives participate in many trade shows in different cities. A woman's apparel rep may participate in as many as 30 trade shows, each of a duration of 3 to 5 days in a given year. The sales representative

often recruits assistance during these trade shows, someone to profile product lines, do paperwork, or model merchandise.

It has been the long-standing practice within the industries I represent to treat this casual labor as independent contractors. Increasingly, however, the IRS has reviewed the relationship between sales representative and their show help and has reclassified that help as employees. The subcommittee is well aware, I'm sure, of the back taxes, penalties and interest that may result from a reclassification.

Recent efforts to reclassify workers has created an atmosphere of paranoia at many trade shows. Sales representatives have heard the horror stories of Mr. Shapiro, an Atlanta-based rep for whom reclassification of show help meant going out of business. They know the story of Arnold H., another rep whose reclassification case could cost upwards of $50,000. Because his appeal is pending, he's unwilling to have his name used in a public hearing, but he would be happy to speak to any member of the subcommittee personally.

The IRS has increasingly refused to acknowledge the safe harbor protections of Section 530 within our industries, despite affidavits from our association confirming that it is the long-standing practice to treat show help as independent, and despite the fact that such classification is prevalent in virtually every apparel and home furnishings mart in America.

IRS's frequent response has been that there is thus a long history of misclassification that should be corrected. This position simply ignores the safe harbor protection of Section 530.

When a sales representative is audited for classification and is found to have misclassified workers, he has two main options: to pay the resulting back taxes and penalties or to challenge the ruling. The reality is that most of these small business persons do not have the resources required to take such an appeal all the way to the U.S. Tax Court.

It is not clear to me that the show help or casual labor that I've described would be protected as independent contractor help under the definitions of the same in either the Christiansen or the Kim bills. For these reasons, I would suggest that H.R. 582 contain some very important wording that is absent in H.R. 1972 pertaining to the maintenance of safe harbors, and somewhat more lenient guidelines for establishing safe harbor protection.

Congressman Kim has done a favor to thousands of small business persons by continuing the safe harbor protection and by defining a significant segment of an industry as not requiring the practice by more than 25 percent of those engaged in the practice.

We acknowledge the need for greater enforcement of the requirement to file 1099s for casual labor to enhance compliance, and we agree that the parties to an independent contractor relationship should document that relationship in writing. But we also feel that the continued use of independent contract labor for trade shows is good for small business and good for the workers involved, as well. We hope that that opportunity can be clarified and maintained.

I would urge the subcommittee to include in any legislation on this issue the maintenance of safe harbor protection and a definition or guideline for establishing that protection.

I thank you for the opportunity to address you and will try to answer any questions that you may pose to me.

[Mr. Wolyn's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. Mr. Bentsen of Texas has come in and didn't have a chance with the first panel. If you would like to start, you're sure welcome.

Mr. BENTSEN. Thank you, Madam Chair.

Mr. Wolyn, you got my attention, in part, because my wife, who was a textile designer in New York before she married me and moved to Houston and I ruined her career, has subsequently been a trade show rep and done some work in the apparel industry on the marketing side because Houston is not known for its apparel industry. It's known for many other things, but that's certainly not one of them. So, I appreciated your comments on that.

I have to say heretofore, we've not run into any problems. In the last year, she didn't have a lot of time to spend working in that industry.

Let me ask Mr. Pyles, and the others may want to comment on this, you brought up the reporting issue and you brought up Medicare, and I don't want to dwell upon Medicare because the Chair and I will have the opportunity to do that probably many times for the remainder of this year, but I have been spending some time in my office reading the trustee's report on the Medicare, in particular the hospital insurance, which is otherwise known as Part A, and actuarial tables and trying to do my own projections and extrapolation, because there's some discussion as to how it will eventually go into default.

Do you think that there is—and I'm sorry I missed the Service when they were testifying earlier, but I was detained—do you think there is a substantial amount of underreporting that we are missing? Is it a billion dollars? Is it billions of dollars?

Mr. PYLES. Well, Congressman, I'm certainly no expert on it and I don't have access to a lot of the figures. At least I'm not as much of an expert as the folks who were on the last panel. But I think we heard from them that they believe there are at least billions of dollars being lost in tax revenue that would be due the United States under the current laws each year.

The coalition that I'm here representing did have a study done last year by Coopers and Lybrand which indicated that if the law was not changed, if the current ambiguities were left in place, that over the next 9 years the Government would lose $35 billion in revenues from folks who should be paying that tax revenue under the existing law.

That hurts two ways. It takes away certainly funds that could be used to provide services to Medicare patients or used for other services, but it also hurts businesses who pay those taxes, who suffer a competitive disadvantage, who pay the unemployment taxes and pay the workman's comp.

For example, under the OSHA requirements for bloodborne pathogens, our companies were required to provide hepatitis B vaccinations to every health care worker. The companies that misclassify their workers, however, just sent their workers to our companies to get the shots, and they hired them back as independent contractors.

Mr. BENTSEN. But if I might quickly follow up, because my time will be limited, but on that, Mr. Shulman, in your testimony you state, in the back, at the end of your testimony, that at a hearing before the Ways and Means Committee you had suggested or your association had suggested various ways to increase compliance and reporting. Could you perhaps expound upon that?

Mr. SHULMAN. Yes, and I think you make an excellent point, and here's where I disagree with Mr. Pyles. This is not a classification problem. This is a tax compliance problem. Once we get people to recognize that payments have to be reported and taxes have to be paid, we're not going to have to worry about Medicare or other things.

There used to be a difference between the self-employment tax rate and the employee-employer tax rate. That was eliminated several years ago. So, now self-employed people have to pay the same tax as employees.

Now, our proposals for increasing compliance, for example, included increasing the 1099 non-filing reporting or issuance penalty from $50, which we think is ridiculous, ridiculously low, to a percentage of the compensation, something like 3 or 5 percent of the compensation on 1099s, with the exception of de minimis noncompliance.

So if you had to issue 250 1099s and you missed three or four of them or there are some small mistakes, no problem, but if you're engaged in an abusive practice, yes, you should not pay $50; you should pay 5 percent of each $10,000 you paid to each of those workers.

Mr. BENTSEN. Of the 1099s that you failed to file?

Mr. SHULMAN. Yes. Also, and this varies industry by industry, for our industry, in the computer industry, we don't have any problem issuing 1099s to corporations. Now, that may not be appropriate for everyone, and it may create problems for some people.

But frankly, in our industry we used to be so compliant to issue 1099s to corporations, from the smallest to the largest. Our members woke up and said, 'That's an audit trail for the IRS. If we deal with 200 independent contractors and 190 of them are incorporated, and we issue 200 1099s, we're going to get audited by the IRS for using independent contractors. Well, let's not issue 1099s to the 190 of them that are corporations, and let's just issue 10 of them and we won't get audited."

I mean, there are so many inconsistencies and problems in the current law regarding the compliance issue that I don't think it takes a lot of imagination to correct some of them.

Mr. BENTSEN. With respect to classification and compliance, and the Chair is a former practitioner, so I think she probably understands this better than I do, and I'm not necessarily advocating this, but does it make any sense to have some form of classification that an independent contractor would fill out that would be a flag for the Service, to provide for some compliance on both sides?

I guess what I'm saying is dealing with the classification issue, rather than having this 20-category subjective list that you have to go through, that you just go ahead and establish it.

Now obviously, there will be some out there who may try and make all of their employees to be some sort of independent contrac-

tor corporation, but does it make sense for the Congress to pursue some form of independent corporate status?

Mr. PYLES. If I could take a crack at that, I guess I do disagree to some extent with my colleague to my left. I do think this really is a classification question because if you're going to connect payment of taxes with employment status, then you have to decide, are we going to rely on the way we have defined employment status in this country for 200 years?

If you're going to do that, if you're going to have control be a factor, and we always have, then you've got to decide, are you going to use the 20 common law factors to determine control or something less? We would certainly favor something easier to apply, but we think, in terms of consistency and in terms of keeping the tax laws consistent with all of the other laws that turn on employment status, you need to keep control in there as a determinant.

Now, I suppose what you could do is break the payment of taxes completely off from the status of a worker—that's a choice you could perhaps make—and essentially eliminate classification of a worker as a test for how taxes are paid.

But understand, these bills cost billions. That would cost many more billions. I think you've got to decide, can Congress afford that?

Mr. SHULMAN. If I may, Congressman, respond to that. Again, we disagree on this point. The notion of competitive unfairness, to me, is something I can't understand. Maybe it's because I've been an employee my whole life. But let's assume I've got two people and each says, "I have a job for you." Now assume one person says, "I want you to work from 8 a.m. to 5 p.m., I'm going to give you training, I'm going to give you the tools you need to do your work, I'm going to give you a pension plan, I'm going to pay your taxes, and if the customer you're working for doesn't need you, then I'll move you someplace else, and I'll pay you even if there isn't work there; I mean, you're my employee; I'm going to take care of you. When one job's over, I'll get you another one."

Now assume that the other person says to me, "Harvey, I've got a job for you as an independent contractor, but you know what? You've got to pay all your own taxes. You get nothing from me. You do all your own training, and as soon as the job's over, you're gone." You tell me who has the competitive edge. Is it the company that's offering me something that is going to really take care of me as an employee, or is it the company that's offering me nothing except the money in hand and a one-time shot at a job as an independent contractor?

Now, those are policy issues that Congress has to deal with and may have some implications outside the tax area. They have implications for overtime, for EEO, for other things. But I'll tell you, the definition of who's an employee for minimum wage and overtime purposes is a completely different definition from the one the IRS uses.

The Labor Department uses a five-factor economic realities test that the Supreme Court, 3 years ago, said is different than the IRS test. So, there is already precedent for saying that in some areas of the law, we use a different test from other areas.

I agree with Mr. Pyles' suggestion. Let's get the IRS out of people's lives and out of business's lives. Let's make tax collection easy, simple. Let's eliminate tax cheating, and the revenues will be there, and then the Government can get involved maybe where it needs to be—protecting people's civil rights or protecting them from overtime abuse—and get them out of people's lives in terms of collecting taxes.

Mr. BENTSEN. I thank, Madam Chair, and I think all of us would agree with that. I think you raise a good issue. Although with your hypothetical, Mr. Shulman, like any economic question, there will be 10 other hypotheticals that you can maneuver as to whether there's a competitive advantage or disadvantage with respect to a contractor or an employee. But my time is up and I thank the Chair.

Chairwoman SMITH. I was enjoying the discourse and the debate because I think that you come down to a question, and I guess I'm going to ask it of all three of you. I told one of you earlier that I started my first business at 11 and I've had several small businesses since, and I think somebody coming in with an organized home health system probably would have had this 11-year-old out on her—well, they would have decided I needed to be an employee. When I started my first in-home business for the elderly, it was many years ago.

I started thinking about the choices. I'd been a pretty independent person all my life and I don't want to be protected. I don't want you to tell me, when I was cleaning houses, that I'm unfair competition to a larger firm that pays benefits. I made that choice.

I guess, philosophically, what I have to ask all three of you, is how does this affect the American dream of us making our own choices, and should the Government be making the policy or setting the policy that we be forced into that so-called safety net of protection of the Government that earlier testimony said had been building for 40 to 60 years?

Hypothetically, is it my fault I'm unfair competition if I'm an individual out there scrapping, and a corporation has built a certain amount of benefits for their employees, or a group—janitorial, whatever—that they see me as unfair competition because my brother and I are working all night and going to school? And I'm serious about that.

Do you believe Government has a responsibility to force this? Because it really makes a difference in this discussion. It looks to me like 90 percent of the IRS cases force individuals into employment. It looks to me like some of the testimony I've heard here and before says that Government does better when people are employees.

I guess, as we have this emergent society, with many more people working out of their homes—and this subcommittee is going to deal with that in the future—whether in textiles or in sales or in whatever; we have to resolve whether our social policy will be pushing people into a box of Government protection, through the employer structure, in the name of protecting the employee, and should we be setting that policy?

Mr. Wolyn, why don't you start?

Mr. WOLYN. We represent independent contractors who are small business entrepreneurs, and I think they would object absolutely to being protected, to the safety net discussion.

Philosophically, they are entrepreneurs. Philosophically, they're into the risk-reward scenario—the higher the risk, the higher the reward. They are, by and large, self-motivated persons. Most of the people we represent are multi-line, multi-product line representatives. Some of them represent up to 130, 140 product lines. Some of them might associate with other independent contractors and may hire.

In the Dallas Mart scenario, where we've had a couple of big cases, we have one in particular where the gentleman has over 500 individuals in the casual labor pool who come in and work for him, three to five shows a year, he issues 1099s to each and every one of those individuals. Quite frankly, the IRS came in and said, "Hey, these are employees."

Well, he complied with every test that we knew at the time, every acid test to determine whether these people were or were not casual labor. Of course, the IRS came in and it cost this gentleman some $60,000 to $70,000.

I had the same scenario occur in Atlanta, where we have a large merchandise mart. Talk about competitive disadvantage. We did a survey down there in one category of merchandise, which was the better area. We had 21 reps that we contacted. One of them had classified his people as employees. All the others were, if you will, casual labor. This individual came back to us and said, "Hey, I'm at a competitive disadvantage. I am forced now to withhold. I am forced to make all these reports that my competitors are not."

I'm away from your question. One of the beauties of this economy, one of the beauties of this country, is that an individual can start one's own business, can bring to the table that which they are trained to or can glean to the table, and can conduct business. I don't see why a person has to be an employee.

One of the problems we have with the test is if I hire a person 1 out of 52 weeks, am I the person who determines how they should be classified? I'm paying that person for a casual labor performance or contract labor performance for 1 out of 52 weeks. Am I the entity that classifies them? And yet that is the position that we are being forced, in many cases, to determine.

Chairwoman SMITH. Thank you. Mr. Pyles, you can hardly stand it. It's your turn.

Mr. PYLES. Oh, I didn't mean to seem overanxious. I apologize if I did.

Chairwoman SMITH. Your body language was very clear.

Mr. PYLES. I was just writing the Gettysburg Address here.

Chairwoman SMITH. Please.

Mr. PYLES. I wanted to get back to a comment the Chairwoman made earlier because I think it reveals a point that we need to discuss here.

You made some mention of the American dream earlier and how perhaps if the IRS forces certain classifications, then workers don't have an opportunity to exercise their rights.

Understand that the bills we're talking about today don't say anything about workers. They do not give the workers a chance to make a decision here. These decisions that are being made by——

Chairwoman SMITH. Mr. Pyles, did you realize there's a written contract in both bills?

Mr. PYLES. There's a written contract which the workers, I suppose, can choose to sign or not sign, but there is no explanation to the workers as to what it means to be an independent contractor or not an independent contractor, which is why we think the provision in H.R. 510 is a great provision, which says that the workers who are classified as independent contractors should be given some indication of what that means, because we've had endless testimony over 5 years of workers who were misclassified without their consent, against their will, loss of health insurance benefits, loss of unemployment compensation, loss of all of the benefits, protections under the Americans with Disabilities Act.

Chairwoman SMITH. So, you recommend that be a part of the contract?

Mr. PYLES. I would recommend that that be a part of the legislation.

But I wanted to get back to your point about the American dream, because I think it's a good one. To own one's business certainly is an American dream, but to expect uniform and fair application of the laws in this country is not only a more basic dream; it is a guaranteed constitutional right.

That's what we, the businesses, the large and small businesses I represent, really request from any legislation, that all businesses be treated fairly and on a level playing field and that the law be clarified in a way that it can be applied by the IRS without arbitrariness and can be understood by the public and cannot be abused by some businesses who seek a competitive advantage.

Sure, there's abuse by the IRS here or arbitrary application, but I hope this subcommittee will not ignore the widespread intentional abuse by businesses who are seeking to damage other small businesses. I assume you represent all small business. I just ask you to hear from the small businesses who are concerned.

As Mr. Baldacci mentioned a moment ago, some regulation, if it's applied evenhandedly, is good. It keeps the bad actors out of the business.

Chairwoman SMITH. Thank you. Yes, and we're hearing from thousands of small businesses right now on this. The White House Conference on Small Business made this its top issue and appears to have weighed in very heavily with the Christiansen bill.

So stay involved in that and keep giving us your input. You made one good recommendation right there. So, stay at the table and we'll end up with a good, clear law.

Mr. Shulman.

Mr. SHULMAN. Yes, if I may respond to your question, let me say our members of NACCB use both independent contractors and employees. What distinguishes us is, as I said, we believe it's a choice that the workers and the companies and their customers made in the marketplace.

We're not pushing the use of independent contractors. We're pushing the freedom to choose.

Now, that being said, let me also tell you what the president of our association told the subcommittee last year. Our members make more money generally when they use employees. Many companies make more money when they use employees. There are lots of reasons for it. It's industry by industry.

So the notion, once again, of one size fits all—i.e., "gee, if you use employees, you're at an economic disadvantage,"—you cannot accept that as the Gospel. It's just not the truth in all situations.

Now, the question about the need to protect workers, I think we would all agree that there are some minimal protections that Government ought to provide. We may disagree what they are, but for anything we always have to ask, what's the price? What is the price to other principles for providing that protection?

When we look at the independent contractor issue, exactly what is the price? We have seen it at these hearings. We've seen it for years. It's a whole bureaucracy of Government people, good, well intentioned people, who are out there spending billions of taxpayer dollars trying to classify people. So we have a bureaucracy.

We also have the intrusiveness of the procedures that I talked about. We also have, at least in our industry—and I can say this, it's happened to people in Texas and elsewhere who it's happened to—when people are forced to become employees, they have a different mentality.

That high-tech entrepreneur who is a computer programmer, who is self-employed, who sold her services to a couple of different companies, who hoped to make it big one day, who maybe hired a subcontractor herself, she had an entrepreneurial spirit. She was creative. She did a tremendous amount, not only to build her business, but to contribute to global competition at the smallest level with that creativity she had in her own office in the hours when she was doing her own stuff, her own product development, as opposed to for a customer.

When you take that person and you make that person an employee, and you say, "Now, you've got to work these hours and you've got to take this training and you've got to go to that customer," people sit back and say, "You know what? I'm an employee, so I'm not going to worry about all this other stuff."

The drive goes out of many people when they're forced to become employees, at least in our industry.

Lastly, let me get to the notion of "control." I agree, the control test is more than 200 years old. It goes back to the Magna Carta. We are now almost in the year 2000. We don't need a test that was used in the year 1800 or the year 1500. We have a high-tech work force that is working not only in so many different ways, but doing things that people 200 years ago probably never even dreamed of.

If we're going to start applying laws that are 200 years old to situations like that, because it's an old law and we're all used to it, we're not going to get anywhere in simplifying the laws, apart from all the other concerns I mentioned about eliminating the entrepreneurial drive and the unfairness to people who want to be self-employed.

So I really commend you on what you're doing. This is a debate, and I appreciate your hearing us out. I realize this is a longer dialogue than you usually allow. But just like the other issues that

we're talking about in this country—whether it's the welfare system or whether it's some of the bigger issues—just like those issues are going to be quintessential issues for the direction that our country goes in, this independent contractor issue is that same type of issue. I look forward to joining on the debate in that one.

Chairwoman SMITH. Well, I have one last question and it needs an answer briefly. We're supposed to probably both be on the floor right now. There are two or three things going on at once.

I was interested this morning to get the IRS's recommendations for training and trying to do something to move some of the review up a level on some of the compliance issues and audit issues, especially the training.

Would you, any of you or all of you, like to comment briefly on that? We do have to be done within about 5 minutes. I think it was new to you probably also. Mr. Pyles?

Mr. PYLES. Well, I've heard what the IRS was doing before. Yes, I would certainly support training and more consistent application of the principles that are out there, as difficult as they are to apply. I think the efforts the IRS has been making to achieve greater uniformity have been helpful, but I don't think you're going to ever truly eliminate this problem until you clarify the definition or the distinction between independent contractor and employee, and that's going to require a statutory change, at least to authorize that clarification.

One last thing I would say is that I would favor—this is a very difficult issue, which I don't think this subcommittee necessarily has all the information it needs, perhaps, to decide—I would recommend a rulemaking process that the IRS would go through, perhaps with limited discretion, have their discretion limited down. At least in that way, this extraordinarily complicated issue, which is important to so many millions of people, will be out in the public mainstream, and the public will have an opportunity to offer its comment. The IRS could perhaps come back; Congress could do an up or down vote.

But I think this is so controversial and so important to so many people, I strongly urge the widest possible apartheid for input from the public.

Chairwoman SMITH. OK, thank you. Mr. Shulman?

Mr. SHULMAN. We agree on one point. I don't think the training is going to work very well. I think there are a lot of very good IRS field examiners and there are a sizable minority of very bad ones. You've got to change attitude, as well as give them the technical skills.

As I said in my comments, it's got to come from the top. The IRS has got to not only accept but embrace the contribution that self-employed workers make to our economy. I don't see that kind of leadership happening.

Apart from that, Madam Chair, a few years ago when I testified on this issue, Senator Kerry from Massachusetts raised some of the problems of the auditors going out and doing things. You could pull out the testimony from a few years ago. It's very similar to the testimony today. We're going to train people. We're going to improve the procedures.

The things I talked about today, the guilty until proven innocent, the contacting the customers and putting people out of business by that, the use of the tax returns of people—I've said this in past years. Nothing has happened.

So I'm glad to hear you say that you're going to look at the procedures, as well as the test, but I agree with Mr. Pyles on this, and we're going to have to have Congress look at the whole issue, not only the substantive test, but the procedures that the IRS uses as it goes about its work in this area.

Chairwoman SMITH. Thank you. Mr. Wolyn.

Mr. WOLYN. I would pose a question. Training for what? Which rule and which law? It's all well and good to say we're going to train, but train for what?

What we want is consistency. We think that you've got enough things out there in 530 and safe harbor, particularly in our industry. Our problem is consistency. It is not being applied consistently. One region might apply it one way, another region apply it another way.

We've been operating our associations for over 50 years. For 50 years we've been operating—I don't want to go back 200 years or go back to the Magna Carta—we have industry standard and practices that we've nailed down I think pretty concisely. Then it comes to the bureaucrats or comes to IRS to interpret, and we wind up with these reclassification audits that are insulting.

Chairwoman SMITH. I thank all three of you. Mr. Bentsen? Final comments or questions?

Mr. BENTSEN. I know we have to get out of here but I do have one thing. It appears to me, first of all, I think we have three issues, as I understand it: Compliance, classification, and possibly disclosure. I appreciated the comments that Mr. Pyles brought up. All those are very difficult and it's difficult to determine how does the Government disclose something and do you overdisclose? We've been through this in other laws.

But I do have a question, Mr. Shulman. I understand what you're saying about those who do not want to be classified as an employee, and the impact, the possible impact that that has on productivity, and I certainly understand that.

I also understand, Mr. Wolyn, the issue of what somebody truly believes is an independent contractor, because of the time they work, when they come in, it's seasonal labor or whatever, and the problems that exist there.

Would you agree that we also have a problem with those who would like to be treated as employees but otherwise are treated as independent contractors? Do you think as much as there are people who want to be treated as an independent contractor, because that's their business; they're an entrepreneur, they're a small business person, whatever; they don't want to work for IBM; they want to sell to IBM, and they want to sell to Digital and to everybody else.

But with downsizing of corporations and all, do you think there are those mid-level executives, whatever, who really would prefer to be an employee, and do we need to look at the other side of the equation: Is there a problem that maybe this law is being abused on the other side by those who would say "We'd just as soon not

have an employee; we'd rather treat them as an independent contractor"?

Isn't there two sides to this problem?

Mr. SHULMAN. That is an excellent question and I'll tell you, there's a couple of different answers. One is, I will guarantee you that most of those people who are hired as independent contractors and who say they don't want to be probably wouldn't be hired at all if the person hiring them were required to employ them.

Now, you may say that's good or bad or whatever, but I just guarantee you there are people who are going to be out there unemployed if you force the so-called employer to make them an employee. It may have nothing to do with taxes or retirement plans or anything like that. It may have to do with just a whole bunch of things about the way companies are organized and whether there's a need for the person for more than a short term, et cetera.

So that's one answer: I think that person may not be employed.

I do agree, there are probably abusive situations, as with anything, where people are forced to do something against their will because they're just kind of in a situation where they have no choice, perhaps, or their choice is limited.

Now, I'll tell you I think those situations are far, far less usual than one would portray the case to be. Therefore, I don't think we let those exceptions create the rule.

Lastly, people are not stupid. If Mr. Pyles' folks want to use these people as employees and they're out there saying, "Hey, we want to hire you and we'll give you this and we'll withhold your taxes and we'll do this and we'll do that," if someone really wants that, if they have that choice—which they do, because he's out there and he wants to hire them as an employee—why would they work for me as an independent contractor, if they're being abused in that capacity?

There's some kind of disconnect. I mean, the marketplace—we're assuming that the marketplace just is completely dysfunctional to allow that to happen, other than in conceivably very unusual and rare abusive situations.

Mr. PYLES. If I may, I'll answer Mr. Shulman's question. The reason is they would pay the workers more because they wouldn't have to incur the 30 percent overhead that comes along with treating someone as an employee; therefore, they can make a 20 percent profit and pay the worker 10 percent.

I will tell you also of a call I got from a nurse in southwestern Virginia, because we represent home health providers. She told me of a company that had reclassified her as an independent contractor, even though she was going into people's homes and providing health care to them. She said she didn't think that was right because she should be and was required by law to be supervised. There was no other home health agency in southwestern Virginia for her to work for.

So Mr. Shulman is right. We also heard testimony from the farmworker in southern Texas who was misclassified and had no one else to work for. So, he's right there. There are many, many workers who are misclassified against their will, and they have no option.

Mr. SHULMAN. Excuse me, Mr. Pyles, but that doesn't make any sense because if that nurse in southwest Virginia felt she needed to be an employee and be supervised, she should have gotten together with her friends or someone else. There was obviously a need for a company there that would hire nurses as employees and supervise them.

That's the entrepreneurial drive. She could have been her own supervisor. If the laws that exist say that a self-employed nurse who is skilled and has passed her licensing and all these other things has to be supervised by somebody else and she can't be self-employed, we need to look at these other laws.

They don't do that with lawyers. I can go to southwest Virginia and open an office as long as I'm licensed. Why should a nurse be treated any differently?

Mr. PYLES. Well, as anyone will tell you, lawyers are totally unsupervised.

Chairwoman SMITH. Thank you, gentlemen. I think this could go on for some time. Are you done with your questioning?

Mr. BENTSEN. Yes, Madam Chairman.

Chairwoman SMITH. We're adjourned.

[Whereupon, at 3:47 p.m., the hearing was adjourned, subject to the call of the chair.]

APPENDIX

OPENING STATEMENT
OF
CHAIRMAN, LINDA SMITH

"Clarifying the Status of Independent Contractors"
August 2, 1995
2:00 p.m., 2359 Rayburn Bldg.

THE SUBCOMMITTEE WILL COME TO ORDER.

I WOULD LIKE TO WELCOME OUR WITNESSES AND GUESTS HERE TODAY. IN TODAY'S HEARING WE WILL EXPLORE THE INTERNAL REVENUE SERVICE'S POSITION ON INDEPENDENT CONTRACTORS, ITS ENFORCEMENT PROCEDURES, AND ITS RECOMMENDATIONS ON A SOLUTION. WE WILL ALSO EXAMINE IRS AND U.S. GENERAL ACCOUNTING OFFICE (GAO) COMPLIANCE STUDIES AND RECOMMENDATIONS, AND WILL HEAR FROM MORE REPRESENTATIVES OF THE SMALL BUSINESS COMMUNITY.

BEFORE WE BEGIN, I WOULD LIKE TO ASK YOU TO KEEP IN MIND THAT THE DELEGATES TO THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS VOTED CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS AS THEIR NUMBER ONE LEGISLATIVE PRIORITY.

IN RESPONSE TO THIS RECOMMENDATION, THE SUBCOMMITTEE'S HEARING ON JULY 26 FOCUSED ON RECENT LEGISLATIVE PROPOSALS, H.R. 1972 AND H.R. 582. REPRESENTATIVE CHRISTENSEN AND REPRESENTATIVE KIM TESTIFIED CONCERNING THE NEED TO ENACT LEGISLATION TO PROVIDE FOR CLEAR, OBJECTIVE CRITERIA.

DESPITE THESE UNAMBIGUOUS PROPOSALS OF THE DELEGATES AND THIS CONGRESS, I AM VERY CONCERNED TODAY THAT THE INTERNAL REVENUE SERVICE (IRS) HAS NOT OFFERED TO WORK WITH THE SMALL BUSINESS COMMUNITY ON CRAFTING A WORKABLE LEGISLATIVE SOLUTION -- CHOOSING INSTEAD TO PROMOTE EXISTING INTERNAL ENFORCEMENT PROCEDURES "UNDER THE EXISTING STATUTORY SCHEME OF WORKER CLASSIFICATION."

WHILE I COMMEND THE IRS FOR AGAIN STATING THAT IT DOES NOT FAVOR EMPLOYEES OVER INDEPENDENT CONTRACTORS, THIS STATEMENT ALONE DOES NOT AND CANNOT FIX THE PROBLEM. NOR DOES IT REFLECT THE "REAL-WORLD" RESULTS OF INCREASED IRS ENFORCEMENT PROCEDURES IN EMPLOYMENT TAX CASES IN RECENT YEARS. AS ONE WITNESS HAS TESTIFIED: "THE CHASM BETWEEN THE RHETORIC OF EMBRACING SMALL BUSINESS AND PROMOTING IT THROUGH MEANINGFUL PUBLIC POLICY IS A WIDE ONE -- THE POLICY HAS BEEN TO AGGRESSIVELY RECLASSIFY INDEPENDENT CONTRACTORS AS EMPLOYEES."

I'M VERY CONCERNED THAT THE ADMINISTRATIVE PROGRAMS THE IRS MAY WISH TO STRENGTHEN AS PART OF ITS PROPOSED SOLUTION ARE ACTUALLY PART OF THE PROBLEM BECAUSE THERE ARE STILL NO CLEAR RULES FOR IMPLEMENTING THEM. FOR EXAMPLE, AS TESTIFIED TO BY REPRESENTATIVES CHRISTENSEN AND KIM ON JULY 26, THE IRS'

ENFORCEMENT PROCEDURES HAVE RESULTED IN THE IRS RECLASSIFYING APPROXIMATELY 439,000 INDEPENDENT CONTRACTORS AND COLLECTING ABOUT $678 MILLION IN TAXES AND PENALTIES SINCE THE LATE 1980'S.

IN PRACTICE, IRS' CURRENT ENFORCEMENT EFFORTS, INCLUDING ITS MOST RECENT MARKET SEGMENT PROGRAMS, ARE BEING IMPLEMENTED BASED ON THE ASSUMPTION THAT "INDEPENDENT CONTRACTORS" MUST BE RECLASSIFIED AS EMPLOYEES IN AS MANY CASES AND INDUSTRIES AS POSSIBLE. PRESUMABLY, THIS VIEW IS BASED ON "LOW COMPLIANCE" ON THE PART OF "INDEPENDENT CONTRACTORS" AND, THEREFORE, LOST REVENUE. TO REACH THIS PREMISE, HOWEVER, THE IRS INCLUDES MANY DIFFERENT TYPES OF TAXPAYERS OTHER THAN TRADITIONAL EMPLOYEES -- INCLUDING WHAT THE IRS CALLS "INFORMAL SUPPLIERS" OR THE "LEGAL UNDERGROUND ECONOMY," AS "INDEPENDENT CONTRACTORS."

I SERIOUSLY QUESTION THE BASIS FOR THIS ASSUMPTION. AS ANOTHER WITNESS HAS STATED, "IT ONLY SERVES TO MAINTAIN THE GENERAL MISPERCEPTION THAT THOSE WHO SEEK INDEPENDENT CONTRACTOR STATUS ARE SEEKING TO AVOID TAXES." WHILE THE IRS SHOULD PROTECT AND COLLECT THE REVENUE -- ESPECIALLY IN AREAS WHERE COMPLIANCE IS A PROBLEM -- IT IS INCONSISTENT AND UNFAIR FOR THE IRS TO CONTINUE TO SADDLE SMALL BUSINESS ENTREPRENEURS WITH THE BURDEN OF COLLECTING THESE TAXES UNDER THE GUISE THAT THEY REPRESENT PART OF THE "INDEPENDENT CONTRACTOR TAX GAP."

IN REALITY, THE IRS AND THE GAO DO NOT KNOW AND CANNOT DETERMINE WHAT PORTION OF THE SO-CALLED "TAX GAP" OR COMPLIANCE PROBLEM IS ATTRIBUTABLE TO INDEPENDENT CONTRACTORS. BUT ACCORDING TO THE GAO IT BELIEVES THAT "MUCH" OF IT IS. THE SUBCOMMITTEE HAS ASKED THE IRS FOR STATISTICAL INFORMATION DESIGNED TO DETERMINE THIS AND OTHER RELEVANT DATA AND THE IRS SIMPLY CANNOT PROVIDE IT.

I AGREE THAT THE IRS SHOULD IMPROVE ADMINISTRATIVE PROCEDURES AND RE-TRAIN AGENTS TO TRULY ACKNOWLEDGE AND PRESERVE THE BENEFITS THAT FLOW FROM PROMOTING INDEPENDENT CONTRACTOR RELATIONSHIPS AND ENTREPRENEURIAL ACTIVITY. BUT THE IRS MUST DO THIS IN SUBSTANCE, NOT JUST IN THEORY. AND, I DON'T SEE HOW IT CAN DO THIS WHEN NO ONE UNDERSTANDS TODAY'S RULES. NEW, CLEAR AND OBJECTIVE LEGISLATIVE STANDARDS TO BETTER DEFINE WHO IS NOT AN EMPLOYEE ARE NEEDED TO PROVIDE THE IRS WITH GUIDANCE IN ITS EFFORTS. THE CART SIMPLY CANNOT COME BEFORE THE HORSE.

TO START, OWN AND MANAGE ONE'S BUSINESS WITHOUT GOVERNMENT INTERFERENCE REALLY IS THE AMERICAN DREAM. CONSISTENCY -- WHILE CRITICAL -- IS INSUFFICIENT WITHOUT A REAL CHANGE IN THE UNDERLYING POLICY ASSUMPTIONS THAT HAVE GUIDED THE IRS FOR FAR TOO LONG. THE KEY TO THE USE OF INDEPENDENT CONTRACTORS IS FLEXIBILITY. WE MUST TARGET COMPLIANCE AT THE SOURCE AND AVOID DOUBLE TAXATION. IT IS VITAL THAT WE MOVE TO A NEW STANDARD THAT RECOGNIZES THESE GOALS, WHILE PROTECTING THOSE AREAS OF THE CURRENT LAW THAT HAVE BEEN RESOLVED.

WITH CLEAR, OBJECTIVE RULES, THE IRS CAN MORE EASILY FOCUS ON COMPLIANCE AND UNDER-REPORTING OF INCOME. THE IRS HAS AND SHOULD HAVE NO DIRECT INTEREST IN WHETHER AN INDIVIDUAL IS AN INDEPENDENT CONTRACTOR OR AN EMPLOYEE, SO LONG AS INDIVIDUALS ACCURATELY REPORT THEIR INCOME. THIS IS WHAT COMMISSIONER RICHARDSON HAS STATED, AND THIS IS HOW IT SHOULD BE. THE OPPOSITE -- TODAY'S SYSTEM -- UNNECESSARILY STIFLES ENTREPRENEURS AND RISK-TAKING.

WE HOPE THAT THE ADMINISTRATION AND THE IRS WILL SUPPORT THE SMALL BUSINESS COMMUNITY IN ITS QUEST FOR CLARIFICATION OF THE STATUS OF INDEPENDENT CONTRACTORS.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Taxation and Finance, Committee on Small Business
House of Representatives

For Release on Delivery
Expected at
2:00 p.m.
Wednesday
August 2, 1995

TAX ADMINISTRATION

Issues Involving Worker Classification

Statement of Natwar M. Gandhi
Associate Director, Tax Policy and Administration Issues
General Government Division

GAO/T-GGD-95-224

TAX ADMINISTRATION: ISSUES INVOLVING WORKER CLASSIFICATION
SUMMARY OF STATEMENT BY
NATWAR M. GANDHI
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Businesses, to determine their tax liability (e.g., employer portion of social security and unemployment taxes on employee wages) and meet the requirements of other laws, need to classify their workers as either "employees" or "independent contractors." But, the common law rules for classifying workers remain as unclear and subject to conflicting interpretations as GAO found them in 1977. Thus, businesses continue to be at risk of large retroactive tax assessments for improperly treating workers as independent contractors.

Given the potential for noncompliance associated with unclear rules and the high levels of income tax noncompliance involving independent contractors, IRS has maintained an active audit presence despite interpretational difficulties. From 1988 through 1994, IRS did 11,380 Employment Tax Examination Program audits (ETEP). These audits resulted in IRS proposing tax assessments of $751 million and reclassifying 483,000 workers.

GAO still believes that the classification rules need to be clarified. GAO also believes that there are two approaches in addition to ETEP that could help improve independent contractor compliance--(1) require businesses to withhold taxes from payments to independent contractors, and (2) improve business compliance with the requirements to file information returns on payments to independent contractors. IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government by individuals but not paid for tax year 1992.

The two approaches, which can be implemented without changes to the classification rules, should help to improve compliance rather than rely on retroactive tax assessments provided for in the law. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.

Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many laws apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers treated as independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net established for American workers.

Madam Chairwoman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors for federal tax purposes. Ensuring the appropriate classification of workers has been of longstanding concern to GAO. Over the years we have issued several reports and presented congressional testimonies which are cited throughout my prepared statement. In the hearing this afternoon, I would like to make 4 points.

-- First: The common law rules used by IRS for classifying workers remain as unclear and subject to conflicting interpretations as GAO found them in 1977. Even the Treasury Department concedes that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification." Yet, in the intervening 18 years, no final action has been taken to clarify the rules as GAO recommended.

-- Second: While recognizing this ambiguity, IRS also feels responsible as the nation's tax administrator to enforce tax laws and rules. Since 1988, IRS' Employment Tax Examination Program has completed 11,380 audits resulting in IRS proposing tax assessments of $751 million and reclassifying

483,000 workers to "employee" status.

-- Third: In addition to classification rule clarification and compliance audits, GAO believes that there are two approaches that could help improve independent contractor compliance--(1) require businesses to withhold taxes from payments to independent contractors, and (2) improve business compliance with the requirements to file information returns on payments to independent contractors. IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government by individuals but not paid for tax year 1992. The two approaches should help improve compliance rather than rely on retroactive tax assessments provided for in the law.

-- And fourth: Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers considered to be independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net

established for American workers.

Before discussing each of these points in detail, I would like to briefly cover some background information to provide context.

BACKGROUND

The rules for classifying a worker as either an employee or an independent contractor come from the common law. Under the common law, the degree of control, or right to control, that a business has over a worker governs the classification. If a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. IRS has adopted 20 common law rules to help classify workers.

If workers are determined to be employees, the business must withhold and deposit income and social security taxes from their wages. In addition, the business pays unemployment taxes and its share of social security taxes. If workers are determined to be independent contractors, they must on their own pay income and social security taxes on payments received from the business.

CLASSIFICATION RULES NEED TO BE CLARIFIED

Until the classification rules are clarified, we are not optimistic that the rather wide-spread confusion over who is an

independent contractor and who is an employee can be avoided. As shown in Appendix I, the misclassification of workers has, in the past, cut across all industries and has involved up to almost 20 percent of the employers comprising some industries.

Although this overview data is now eleven years old, little has occurred to improve the situation. The Treasury Department characterized the situation in 1991 in the same terms as it used in 1982; namely that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification." But, as a means to limit IRS' authority to reclassify independent contractors to employee status, IRS has been precluded from issuing clarifying regulations since passage of the Revenue Act of 1978.

Given such confusion, one should expect misclassifications to occur. For 1984 IRS estimated that about 750,000 of 5.2 million employers had misclassified about 3.4 million workers as independent contractors. Assuming no change in the misclassification rate, this noncompliance produced an estimated tax loss for 1992 of $2 billion.[1] However, IRS officials believe that misclassifications have been increasing. Recent estimates by the Commissioner of IRS place the current tax loss

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[1]Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

at about $3 billion to $4 billion.

Also arguing for change is that, under the current tax rules, similar businesses are not necessarily required to be treated equally. Section 530 of the Revenue Act of 1978 provided qualifying businesses with some safe harbors for determining who is an employee and who is an independent contractor.[2] In 1989 we reported that for the cases reviewed, given the requirements of section 530, IRS could not assess $7 million of $17 million in recommended taxes and penalties against employers for misclassifying employees.[3] The employers usually avoided the assessments by claiming a prior audit protection clause, even when the prior audit did not intend to address employee classification issues or when it occurred over 20 years earlier. Therefore, for some businesses a prior audit may be the distinguishing feature for determining the employment status of their workers.

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[2]Under section 530, IRS may not assess employment taxes for misclassified workers against a business that had a reasonable basis for its classification, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly.

[3]Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sep. 25, 1989).

GAO's Simplification Proposal

For these and other reasons, we have supported measures to simplify the classification criteria.[4] We also have supported measures to allow IRS to issue clarifying regulations, and authorize IRS to require employers with section 530 protection to prospectively reclassify independent contractors as employees.[5]

To make the classification decisions more certain, in 1977 we proposed a rather straightforward test. As in common law, our test recognized that one of the prime determinants as to whether a worker is an employee or independent contractor is the degree of control, or right to control, the employer has over the worker. For example, the right to direct and control the manner and details of a worker's performance suggests an employer/employee relationship.

But our test was designed to clearly recognize that where separate business entities exist, some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without necessarily creating an employer/employee relationship. Our test was also intended to

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[4]Tax Treatment Of Employees And Self-employed Persons By The Internal Revenue Service: Problems and Solutions (GGD-77-88, Nov. 21, 1977).

[5]Tax Administration: Improving Independent Contractor Compliance With Tax Laws (GAO/T-GGD-94-194, August 4, 1994).

provide a clear standard to assure that only legitimately independent workers would qualify for independent contractor status.

Therefore, we proposed that the Internal Revenue Code be amended to exclude workers from the common law definition of employee in those instances where they:

-- Have a separate set of books and records which reflect items of income and expenses of the trade or business;

-- Have the risk of suffering a loss and opportunity of making a profit;

-- Have a principal place of business other than that furnished by the persons receiving the services; and

-- Hold themselves out in their own name as self-employed and/or make their services generally available to the public.

We also recognized that there may be some situations where a worker is able to meet some but not all of the above criteria and still have a valid basis for being considered self-employed. In these circumstances, the common law criteria should be applied. But, if an independent contractor could not meet at least three

of the above four criteria, we believed that the worker should be considered an employee.

Reaction to GAO's Simplification Proposal

At the time, our proposed solution was not widely accepted. Treasury and IRS were concerned that any change in the law which increases the number of self-employed would result in lost tax revenue. This was because IRS had found that self-employed taxpayers had a low compliance rate in reporting income earned. More recent IRS data suggest that although independent contractors have represented only a small proportion of taxpayers, they have accounted for as much as $21 billion to $30 billion of income taxes owed the federal government but not paid by individuals for tax year 1992.[6] Also, the Departments of Justice and Labor were concerned that the criteria would permit taxpayers to be considered self-employed when they have the form but not the substance of self-employment.

These comments have not changed our mind about the potential for developing a clearer test. Given the continuing confusion over worker classification, we believe the abbreviated test that we

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[6]Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994). Because there is no generally accepted definition of the term independent contractor, the report developed statistics on service providers as a surrogate measure since many are considered by IRS and the business community to be independent contractors.

put forward in 1977 still has relevance and can provide a good starting point for the current deliberations.

IRS ENFORCEMENT

While recognizing the ambiguity in the classification criteria, IRS is responsible as the nation's tax administrator to enforce tax laws and rules. Because of the misclassification difficulties and continued high level of tax noncompliance of independent contractors, IRS centralized a portion of its employment tax compliance efforts into an Employment Tax Examination Program (ETEP) during 1987. IRS' strategy is to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. Doing so consolidates and facilitates IRS' tax collection instead of tracking whether numerous independent contractors paid their taxes.

From 1988 through 1994, IRS has completed 11,380 ETEP audits. These audits resulted in proposed tax assessments of $751 million and reclassifying 483,000 workers as employees. The average tax assessment was about $66,000 per business. In addition, the IRS Examination Division auditors, as part of their regular tax audits, also address classification issues. However, the Examination Division does not accumulate data to identify audit results that involve classification issues.

APPROACHES FOR IMPROVING INDEPENDENT CONTRACTOR TAX LAW COMPLIANCE

In addition to classification rule clarification and ETEP, we believe other approaches could be adopted to improve independent contractor compliance. These approaches would (1) require businesses to withhold taxes from payments to independent contractors and (2) improve business compliance with the requirement to file information returns on payments to independent contractors.

These approaches, which can be implemented without changes to the classification rules, should help to promote compliance through means other than retroactive tax assessments provided for in the law. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.

Requiring Withholding on Payments to Independent Contractors

Withholding is the cornerstone of our tax compliance system for employees. It has worked well with over 99 percent of wages voluntarily reported. In addition, it provides a gradual and systematic method to pay taxes and insures credit for social security coverage.

As early as 1979, we concluded that noncompliance among independent contractors was serious enough to warrant some form of tax withholding on payments to them.[7] IRS studies since the 1970s have documented a lower level of compliance by independent contractors compared to employees.

We continue to believe that a withholding approach has merit, despite several administrative problems that would need to be resolved. The most important consideration in any withholding system is that the tax withheld approximates the tax due for the year. Independent contractors can have substantial business expenses that reduce annual net income and taxes owed. In such cases, withholding could adversely affect cash flow. Because such expenses may vary among independent contractors, a graduated withholding system to account for differences in expenses could be used. A simpler approach for businesses would be to withhold a flat amount (e.g., 5 percent) of all payments.

Another problem is that independent contractors may circumvent withholding by incorporating. To avoid this problem, withholding would need to apply to corporations. Large corporations may view withholding on payments to them as unjustified since IRS data suggest that their voluntary compliance exceeds that of self-employed workers.

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[7]Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

Also, it is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal developed by the Treasury Department in 1979 would have exempted independent contractors who (1) normally work for 5 or more businesses in a calendar year or (2) expect to owe less tax than the withheld amount. Because some independent contractors may be exempt, it would be important to complement any withholding system with an effective information reporting system.

Improving Information Reporting on Payments to Independent Contractors

A second approach to enhance compliance--improving information reporting--parallels the withholding approach by placing less emphasis on unclear classification rules and shifting the emphasis to the relatively clear laws on information returns.[8] Focusing on information returns can have a significant effect. IRS data has indicated that, when information returns are filed, misclassified workers reported 77 percent of that income on their tax returns but only 29 percent of the income not covered by information returns.

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[8]In general, certain third parties (e.g., businesses and banks but not individuals such as homeowners) are required to make annual information filings with IRS to report various payments made to unincorporated individuals, such as payments for services rendered and interest and dividends. The information is also reported to the individuals receiving the payments.

While other options may exist, we identified eight that could strengthen information reporting and close potential loopholes. For the most part, we identified the options through our past and ongoing work on information reporting, independent contractors, and other compliance issues.[9] These options, each of which has pros and cons, are as follows:

(1) Significantly increase the $50 penalty for not filing an information return.

(2) Do not penalize businesses for past noncompliance with information reporting laws if they begin to file information returns when the penalty is increased.

(3) Require IRS to administer an education program to make the business community aware of the filing requirement and of IRS' intention to vigorously enforce it.

(4) Lower the $600 reporting threshold for payments to independent contractors.

(5) Require information reporting for payments to incorporated independent contractors.

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[9]Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

(6) Require businesses to separately report on their tax return the total amount of payments to independent contractors.

(7) Require businesses to validate the tax identification numbers (TIN) of independent contractors before making any payments, and for those with invalid TINs, withhold 20 percent of payments until the TIN is validated.

(8) Require businesses to provide independent contractors with a written explanation of their tax obligations and rights.

Each of these options involve tradeoffs between taxpayer burden and tax compliance. A summary of the pros and cons of each option is in Appendix II to my statement.

IMPLICATIONS FOR THE SOCIAL SAFETY NET FOR AMERICAN WORKERS

Aside from tax issues, changes to the classification rules need to be cognizant of the body of laws that create a safety net for American workers. Many laws apply only to employees but do not protect workers classified as independent contractors. Because a byproduct of classification rule clarification is the potential for changing the number of workers considered to be independent contractors, we believe the current deliberations should also focus on potential impacts on the social safety net established

for American workers.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. This 60-year old program provides short-term financial support for covered workers who, through no fault of their own, become unemployed. It also helps the unemployed from having to turn to public assistance programs. Moreover, in times of economic downturns the payments made to the unemployed may take on added significance, serving a macro-economic role of helping to stabilize the economy during recessions. However, federal law does not require coverage of independent contractors for unemployment insurance, although one state (California) has provisions that would allow independent contractors to apply for self-coverage.

While we have not made an extensive survey of labor law to determine all affected laws, they are quite numerous, ranging from basic protections such as minimum wage, overtime, age discrimination in employment, and occupational, safety and health requirements to access to workers compensation insurance and employer-sponsored, tax-qualified, fringe benefits such as pensions and welfare benefit plans. Thus, for example, should clarification of the tax standard for differentiating between employees and independent contractors result in significant reclassifications of employees to independent contractors, then the worker protection laws would cover fewer people.

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That concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.

APPENDIX I

Table 1: Percentage of employers with misclassified workers, 1984.

Industry	Percent of total
Construction	19.8
Finance, Insurance, Real Estate	19.3
Mining, Oil and Gas	18.6
Agriculture	16.7
Manufacturing	15.8
Services	15.4
Transportation	11.2
Wholesale and Retail Trade	9.6
Government	9.6
Not Otherwise Classified	12.6
Total	13.4

Source: Treasury Department

OPTIONS FOR IMPROVING INFORMATION REPORTING ON PAYMENTS TO INDEPENDENT CONTRACTORS

In addition to discussing clearer classification rules and withheld taxes on payments to independent contractors, our 1992 report (Tax Administration: Approaches For Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992) discussed information reporting. Specifically, we analyzed options for improving the reporting on payments made to independent contractors. The options follow.

Options	Pros	Cons
(1) Increase $50 penalty for failure to file an information return (Form 1099-MISC).	Should improve compliance in filing Form 1099-MISC. Should increase income reported and taxes paid by independent contractors. Would encourage IRS to check Form 1099-MISC filing during audits. Would discourage businesses from agreeing to not file Form 1099-MISC if they can make lower payments.	Would complicate IRS administration if other penalties for failure to file Form 1099-MISC are $50. Would cause equity concerns if one penalty was higher than others.

(2)	Do not penalize businesses for past Form 1099-MISC. noncompliance if they begin filing.	Would encourage filing compliance. Would ease the transition to a higher penalty for not filing Form 1099-MISC.	Would not punish past noncompliance. Would result in lost penalty revenue. May raise expectations of future penalty forgiveness.
(3)	Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.	Should increase business compliance with filing Form 1099-MISC.	Would add to IRS' costs or use funds that could be used for other educational purposes.
(4)	Lower the $600 Form 1099-MISC. reporting threshold.	Would include more payments in IRS' computer match to detect unfiled Form 1099-MISC forms and unreported income. Should improve independent contractor compliance. Would mirror other lower thresholds (e.g., $10 for royalties).	Would increase costs to businesses to file more Form 1099-MISC. Would increase costs to IRS to process and match more information returns. May exceed current IRS computer capacity.

(5)	Require businesses to report payments made to incorporated independent contractors.	Would deter attempts to avoid information reporting. Businesses would not need to distinguish between incorporated and unincorporated workers.	Would increase costs to businesses to file more Form 1099-MISC. Would increase costs to IRS to process and match more Form 1099-MISC. May exceed current IRS computer capacity.
(6)	Require businesses to separately report on their tax return the total amount of payments to independent contractors. IRS would match amounts reported on tax return and on information returns.	Should increase Form 1099-MISC compliance. Could enhance IRS' ability to detect noncompliance. Give tax return preparers more incentive to check compliance.	Will not stop some businesses from hiding payments to independent contractors. May increase some businesses' costs to report the information.
(7)	Have businesses validate Taxpayer Identification Numbers (TIN) before making payments. If TIN is invalid, a business must withhold taxes beginning with first payment and continue withholding until a TIN is validated.	Should improve IRS matching and increase taxes collected. Should make backup withholding more cost-effective by reducing it or starting it with first payment to independent contractors.	Would add burden for businesses to validate TINs before paying contractors. Would increase IRS' equipment costs.

(8)	Have businesses notify independent contractors of their rights and obligations to pay taxes as self-employed workers.	May improve voluntary tax compliance. Would encourage workers who believe they are misclassified to notify IRS. Would inform workers of their rights and obligations.	Would add burden on business to make the appropriate notifications.

COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON TAXATION AND FINANCE

HEARING ON "CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS"

AUGUST 2, 1995

Submitted by: James C. Pyles, J.D.,
Counsel for the Home Health Services and Staffing Association

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Madam Chairwoman and members of the Subcommittee, I am James C. Pyles, counsel for the Home Health Services and Staffing Association ("HHSSA"), which is an association of small and large businesses providing supplemental nursing staff to health care facilities and home health services directly to patients. HHSSA is a member of the Coalition for Fair Worker Classification, which includes representatives of associations of large and small businesses, management and labor, who feel that legislation is needed to curb the intentional abuse of the independent contractor designation. The associations that are members of the Coalition represent thousands of businesses and millions of workers nationwide.

The Coalition represents the businesses that take the trouble to determine how the employment tax laws apply to their activities and comply with the law. The Coalition does not oppose the legitimate use of the independent contractor status but is opposed to the pervasive and growing practice of some businesses to ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies. We certainly do not favor the arbitrary enforcement of the law by the IRS, but we believe that a much greater danger to small and large business is the intentional abuse of the employment tax laws as a corporate strategy to gain a competitive advantage and maximize profits.

Certainly, the anecdotes of individuals that have been subjected to heavy penalties for misclassifying workers generate sympathy. But what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, and incur the other overhead costs associated with the designation of workers as employees? For example:

1. What about the concerns of the building service contractor in the deep South who has to lay off 4,000 workers and loses $5 million a year to competitors who misclassify workers as independent contractors?

2. What about the manufacturers in the garment industry in Dallas, Texas who have been driven out of business by companies that produce clothing at cut rate prices by using illegally classified independent contractors?

3. What about the company that loses a multimillion dollar government shipbuilding contract in Groton, Connecticut because its competitor reclassifies all of its workers as independent contractors and is a thereby able to submit a lower bid?

4. What about the small supplemental medical staffing company in Parma, Ohio that loses its principal hospital contract because a competitor offers to provide the same services through independent contractors in violation of the IRS' consistent rulings?

5. What about the concerns of workers who are deprived of health insurance, overtime pay, and protections of the Child Labor, workmen's compensation, and unemployment compensation laws by employers who misclassify them as independent contractors without their approval or against their will?

Where do the concerns of these individuals and businesses get taken into account?

The sponsors of H.R. 1972 and 582, as well as delegates to the White House Conference on Small Business, are to be congratulated for bringing the issue of fair worker classification to the forefront of the 104th Congress' agenda. Unfortunately, however, the solutions proposed in those bills fail to address the underlying problems and, in fact, will make those problems worse.

No one would dispute that the common law test, which is required by statute to be used to distinguish between employees and independent contractors, is based on a 20 factor test which is ambiguous and difficult to apply consistently. Enforcement of that law is made virtually impossible by § 530 of the Revenue Act of 1978, which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee. Accordingly, this hopelessly ambiguous area of the law has not been clarified because § 530 forbids it.

Section 530 produces numerous anomalous results. For example, a business that has had an IRS audit for any reason since 1977 can misclassify workers with impunity forever into the future. Businesses that have misclassified workers in violation of the law and can cite examples of significant similar misclassifications among their colleagues also receive lifetime immunity. Section 530 also imposes a virtually impossible burden of proof on the IRS by establishing a presumption that an employer has a reasonable basis for not treating the worker as an employee unless the IRS can prove the negative -- that no such reasonable basis exists.

H.R. 1972 and 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal § 530 but rather simply adds a definition of individuals who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although H.R. 1972 professes to be intended to clarify the existing law through the addition of "objective" standards, the criteria contained in the bill are vague and would be impossible to clarify. For example, the bill would permit workers to be classified as independent contractors if they had a "significant" investment in assets or training or had "significant" unreimbursed expenses or agreed to perform the service "for a particular amount of time." None of these key terms are defined and, with the prohibition on clarification in § 530 unrepealed, no clarifying regulations could be issued.

Further, the criteria completely ignore the issue of control which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors. For example, a worker could be classified as an independent contractor even though the workers' every movement was controlled by the employer if the worker paid for his or her own education or had school loans. A worker under a similar degree of control could also be classified as an independent contractor if he agreed to complete a job in ten years or within his lifetime, since that would clearly be "a particular amount of time."

Accordingly, the effect of H.R. 1972 would be to make the classification of most workers completely discretionary for most employers.

In addition, H.R. 1972 does not incorporate a "consistency" principle, which appears even in § 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today, as independent contractors tomorrow, and as employees again the next day. Such manipulation of the work force is likely, since it would enable businesses to qualify for certain contracts and loans as small businesses regardless of the size of their actual work force.

Even though H.R. 1972 is ostensibly directed at an issue identified by the small business community, the provisions of the bill apply equally to big business. Thus, it would appear that the bill may trigger massive reclassifications on an initial and continuing basis.

H.R. 582 is a somewhat better piece of legislation in that it is less vague and repeals § 530. We do not favor this legislation, however, because it incorporates the safe harbors of § 530 into the Internal Revenue Code and retains the illogical and inequitable "prior audit" safe harbor.

Both bills suffer from the problem that they are likely to cost the government billions of dollars in lost tax revenue. We understand that H.R. 582 has already been scored by the Joint Committee on Taxation as costing nearly $600 million over 5 years. That amount is likely to increase to nearly $1 billion over the 7 year planning horizon used for budgeting purposes. We believe the cost of H.R. 1972 will be much higher, because the criteria are more liberal and it contains no funding source, such as increased fines for failure to file information returns, as does H.R. 582.

A study performed by the accounting firm of Coopers and Lybrand last year concluded that misclassification of workers under the current law will cost the government approximately $35 billion over the next nine years. The cost would obviously be higher if the employment tax laws were liberalized, as proposed in these bills. This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting $270 billion over 7 years from the Medicare program on which many of our nation's frail elderly depend.

At the very least, H.R. 1972 should be scored to determine the extent to which cuts would have to be made in other programs to fund the loss.

Rather than legitimizing the abuse that is currently occurring at the cost of billions of dollars in desperately needed tax revenue, we recommend a more moderate approach that still addresses the concerns identified at the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Congressman Tom Lantos. That bill provides for the following:

1. It removes the prohibition on the issuance of regulations clarifying the distinction between employees and independent contractors.

2. It allows an amnesty period for employers to properly classify workers without penalty.

3. It provides for notification of workers of the consequences of being classified as independent contractors so they can make informed decisions about where they work.

4. It narrows the "prior audit" safe harbor to apply only in cases of prior audits that actually considered the employment tax issue.

Although this bill has not yet been scored, we believe it will generate moderate savings and will clarify the rules for distinguishing between employees and independent contractors in a manner that does not substantially redraw the boundary and in a way that is more consistent with other federal and state laws.

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TESTIMONY OF
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ON

CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS
-- IRS ENFORCEMENT AND COMPLIANCE ISSUES --

BEFORE THE
SUBCOMMITTEE ON TAXATION AND FINANCE
OF THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

HEARINGS, AUGUST 2, 1995

The National Association of Computer Consultant Businesses is the largest association exclusively representing companies providing highly-skilled computer and engineering professionals on a contract basis to customers, including most Fortune 500 firms, who need temporary project support. Our 230 member firms have over 500 offices with combined annual revenues of over $2 billion, and they use both employees and independent contractors.

NACCB is committed to the principle that workers and businesses should have the freedom to establish either an independent contractor or employment relationship, guided only by marketplace forces and individual preferences. Aside from assuring that taxes are paid in such relationships, the government should have a limited role that does not dictate a worker's status.

Our testimony today is informed by our unfortunate experience as the only industry without any employment tax safe haven. As such, in IRS audits we suffer the most stringent enforcement of worker classification rules because Section 1706 of the 1986 Tax Reform Act eliminated from only our industry the opportunity to treat a computer or engineering consultant as an independent contractor under so-called employment tax safe haven rules. The IRS audits in our industry not only substantially interfere with the type of marketplace forces and individual preferences that we should encourage, but they deter entrepreneurship in the high-tech industry and threaten the very existence of businesses that use self-employed high-tech workers. As this written testimony addresses in more detail later, the Section 1706 experiment has failed drastically. A Congressionally-ordered Treasury Department study shows that our industry has higher-than-average tax compliance and that Section 1706 may, in fact, cause tax revenues to be lost. A strong consensus

has emerged to repeal Section 1706 and, whatever other reforms are made in regard to the independent contractor issue, the discriminatory treatment of our industry must be eliminated.

Today, however, my main focus is on the broader question of employment tax audits as they affect all industries and all self-employed workers. In brief, NACCB urges Congress to reform the fundamentally unfair procedures that the IRS uses in levying an assessment for employment taxes, to clarify the substantive rules by which workers are classified as either employees or independent contractors, and to improve tax compliance without worker reclassification. In this regard: First, small business taxpayers must have the right to a court trial in employment tax situations before being subject to an assessment and a lien (absent fraud or similar misconduct), just like taxpayers in other audits. Second, unfair IRS investigative practices must be curbed, including the IRS's targeting of customers of businesses which use the services of independent contractors and the IRS's misuse of an independent contractor's confidential tax return information against those businesses. Third, Congress should adopt the substantive standards in Congressman Christensen's bill, H.R. 1972, and amend Section 530 of the 1978 Revenue Act in some regards as proposed by Congressman Kim in H.R. 582, including the repeal of Section 1706. Fourth, Congress should increase tax compliance measures and penalties for noncompliance, and do so without forcing businesses to convert independent contractors to employees.

I. General Perspective on the Independent Contractor Issue

As general counsel of NACCB, and as a partner in the Washington, D.C. law firm of Ginsburg, Feldman & Bress, within the past few years I have been personally involved in over 40 IRS employment tax proceedings all over the United States. I have seen the harm caused to small and mid-sized businesses by the IRS as it attempts to reclassify tens of thousands of independent contractors as employees. I have experienced the implementation of a process that too often disgraces our tax system, subverts our economic system, and mocks our system of justice and law.

Before providing you with specific and detailed comments, let me emphasize -- based upon prior testimony from IRS Commissioners and their top officials, as well as my own experience -- that I do not believe that there is any conspiracy in the IRS national office to eliminate independent contractors. Rightly so, top IRS officials insist that in attempting to insure that employment taxes are collected, they must implement a difficult

and confusing law set of employment tax standards. Indeed, in the field, the vast majority of IRS auditors are honest, well-intentioned and fair-minded persons who are simply trying to do their jobs.

Unfortunately, however, rarely do we hear top IRS officials saying that as their agency goes about its mission of collecting taxes, it recognizes that all businesses -- small, mid-sized and large -- can and do reap benefits from using the services of self-employed workers who are entrepreneurs, work hard, contribute to our economy, and are helping us develop a flexible workforce for the 21st century. Instead, the word "independent contractor" is often uttered only when accompanied by words like "tax noncompliance", "tax cheating", "unfair competition", and "worker coercion". Indeed, many others -- including the GAO -- have fallen into this same mindset. As a result, we have lost sight of what is at stake, and we have gotten to the absurd result that the IRS policy actually allows for the collection of the same taxes twice -- once from self-employed workers and again from businesses which use their services.

In these circumstances, it is not surprising that too many field auditors on the IRS front-line -- even the well-intentioned and fair-minded ones -- view self-employed workers and businesses which use their services as some sort of disease that needs to be cured. Nor is it surprising that a sizable minority of field auditors see themselves as zealous prosecutors who should be able to use any means -- other than those specifically prohibited -- to catch these alleged tax-cheats. As one IRS auditor said to me in a major Midwestern state, in words like these, "By the time we finish audits of the computer industry in this state, there won't be any more self-employed computer consultants left here." This type of thinking has got to stop.

Congress needs to send a wake-up call to our bureaucrats. I urge this Subcommittee to use its podium in Congress to push hard for essential reforms in the independent contractor area. These reforms fit into two general areas: (1) the procedural legal standards under which the IRS should operate as it makes a determination of a worker's status, whether that status is determined under current law or a new law like H.R. 1972; and (2) the substantive legal standards under which worker status as an independent contractor or employee will be determined.

Thus far in these hearings, the primary focus has been on the second area, i.e., the substantive legal standard. Although I will comment on that area at the end of my testimony, I want to begin by looking at the procedural standards that the IRS uses in its audits.

II. Procedural Standards

Too often when the independent contractor issue is addressed, the focus has been solely -- or at least primarily -- on the substantive legal standard for determining who is an independent contractor and who is an employee. Unfortunately, little or no discussion is directed at the procedures that the IRS uses in its interactions with taxpayers.

Simply put, we believe that many of the procedures used in employment tax audits are unacceptable in a democratic society. As our sense of fairness and justice has evolved over the years, and as more emphasis is being placed on eliminating intrusive conduct by government agencies, we need to revise the way the IRS conducts employment tax audits under whatever substantive legal standard it may use.

In one sense, the inherent ambiguity and unpredictability of the common law employment test itself has effectively invited IRS auditors to intrude into the lives of our businesses and self-employed workers beyond that which would normally be tolerated in our society. Often, in remarking on the heavy-handedness of IRS practices, I have been told that "we are collecting taxes" and that "even though other federal agencies might not be able to engage in similar practices, an exception has always been made for the IRS."

We have got to turn this thinking around. A small or mid-sized business undergoing an IRS investigation is entitled to no less procedural protections that a business being investigated by any other federal agency. Likewise, we must provide such businesses involved in employment tax audits the same procedural protections -- particularly against IRS assessments and liens -- as are enjoyed by businesses undergoing income tax audits. We now have a system that includes procedures which look are more consistent with the old Soviet Union or China, as opposed to the U.S. approaching the 21st century.

Among the IRS employment tax audit procedures and practices that must be changed (there are many others) are the following.

A. Small business taxpayers are not afforded the right to a court trial before the IRS makes an actual assessment of employment taxes -- which becomes an automatic lien on their businesses that could jeopardize the existence of that business.

The most fundamental procedural change that must be made in our employment tax laws is to give a business its "day in court" in front of an impartial judge, and with appropriate legal discovery, before the IRS can make an actual assessment and impose a lien on a business for unpaid employment taxes. As it is, all taxpayers -- businesses included -- must effectively

prove in court that they are "innocent"; it is not the burden of the IRS to prove in court that the business owes the additional taxes that the IRS chooses to impose. Yet particularly in employment tax disputes -- where the 20-question common law employment test is so ambiguous and unpredictable -- it is grossly unfair to require a business to labor under the dual burden of proving itself "innocent" in court and trying to continue to operate under the weight of an IRS assessment and lien.

Unlike income tax audits where no assessment can be made or lien can be filed until after a fair court trial, IRS filing of a lien in employment tax cases -- or even an IRS assessment without the filing -- is the method in the Internal Revenue Code by which the IRS must handle employment tax audits. Yet this IRS action leads many financial institutions to cut off a small business taxpayer's line of credit. A court might ultimately rule in favor of the taxpayer in a refund suit when the taxpayer proves itself "innocent", but the taxpayer might be out of business before then because of the lien.

We must change this process so that employment tax disputes are handled like other tax disputes. Absent a situation in which a business withholds employment taxes from a worker's pay and fails to pay it over to the IRS, or absent fraud or similar misconduct (e.g., jeopardy situations), a business engaged in a good faith dispute with the IRS over the classification of workers and the payment of employment taxes should not be subject to an assessment or a lien. Instead, it should be entitled to the same procedural safeguards as businesses involved in income tax audits. We urge this Subcommittee to recommend this vital change to the Internal Revenue Code.

B. IRS auditors unfairly engage in contacts with customers and self-employed workers of a small business taxpayer which threaten to harm the taxpayer's business.

In many cases, IRS auditors make unannounced visits to homes or offices of a taxpayer's self-employed workers and customers and they demand immediate interviews; in other cases, letters are sent to workers or customers stating that they should present themselves at a designated time at IRS offices, along with documents that may include their own tax returns, in order to answers questions about their relationships with the taxpayer under audit. These intrusive practices are regularly justified by the IRS as necessary to gather all of the "facts and circumstances" required to make an employment tax classification decision under the 20-factor common law employment test -- which is another reason to eliminate that employment test.

As a result of such IRS contacts, many workers and customers no longer want to do business with the taxpayer about whom they are being questioned. In the end, the business may "win" its IRS audit, but be threatened with going out of business by the reactions of its workers and customers to IRS visits.

As one auditor in the Northeast said to me earlier this year about her plans to contact customers and workers of a business taxpayer, "That's what we call life in the 'audit lane' in this office. That's your problem, not ours." This auditor candidly stated what several other auditors have stated to me in more careful language. NACCB strongly opposes these practices and asks that limitations be put on them.

C. IRS auditors use "selective" information from the income tax returns of a small business taxpayer's self-employed workers to make employment tax assessments and impose liens against the small business -- and then the auditors refuse to allow that small business taxpayer the opportunity to see those same returns in order to assure that the information is correct and has not been taken out of context, and/or to rebut it.

Particularly within the last few years, as computerization has increased the access of IRS auditors to individual self-employed worker tax returns, these auditors have more often used information on such returns in the audit of a business that paid those workers. For example, an auditor might say to a business that an independent contractor paid by it is not a valid contractor -- and thus the business must pay employment taxes -- because the contractor's tax return doesn't include enough evidence of self-employment (e.g., the IRS may believe there are inadequate business expenses, advertising and hiring of assistants); none of this has anything to do with the fact that the contractor may have already paid the employment taxes, which the IRS nonetheless still tries to collect from the business. This tax return information, used by the IRS to collect more taxes from the business, is not revealed to the business. The IRS justifies its conduct by saying that information on worker returns is relevant to all of the "facts and circumstances" required to make an employment tax classification decision under the 20-factor common law employment test -- which is again a good reason to eliminate that employment test.

Not surprisingly, therefore, it is not uncommon for an assessment and lien of several hundred thousands dollars or more to be imposed against a small business and to be based in large part upon "secret" information that the IRS will not share with that business. In fact, in many such cases, the mere existence of the assessment and lien can lead to the loss of a line of credit or other financing that the business needs to remain in business.

In almost every setting -- other than perhaps situations like those involving national security -- it would be unheard of for the government to use "secret" information against a person or business that could destroy that its livelihood or assets. In fact, we would normally say that this is a denial of due process in a civilized society. Yet this regularly happens in IRS audits. As one auditor said to me, "Of course we can use worker tax return information against your client and not let you see it. I understand how it seems unfair, but that's just the way it's done." Congress needs to stop this from happening.

D. Too many IRS auditors conduct one-sided investigations in employment tax examinations that intentionally ignore facts which do not support their proposed assessments -- and they express little concern if their analyses are later rejected by an Appeals Officer or a court.

A majority of IRS auditors conduct fair investigations. However, contrary to what you may be told, a large percentage of IRS auditors act as zealous "prosecutors", rather than impartial fact-finders in their employment tax audits. They see their goal as building a case against a small business, which the small business must disprove. Faced with a 20-factor common law test for classifying workers, they focus on a small group of factors -- it may be 5 or 8 -- that "go against" the taxpayer. Here again, the mere existence of the ambiguous 20-factor test encourages this type of conduct.

We cannot let employment tax audits continue to be conducted in this manner. Auditors must be required to gather facts on <u>all</u> of the factors, whether the facts support the IRS or the taxpayer. Auditors should be required to balance those facts, and weigh the legal standards, in an objective manner. Moreover, they should be evaluated in part on whether their findings and conclusions have survived scrutiny by the IRS Appeals Office and a court which may later review such assessments. Right now, there is simply little if any accountability for what happens later in the process -- and this only encourages the prosecutorial zeal held by too many auditors.

E. IRS auditors can privately "lobby" appeals officers who are assigned to rule on taxpayers' protests of assessments proposed by those very auditors, and taxpayers rarely learn about -- and have right to rebut -- such facts and arguments that are privately provided.

Here again, it offends the sense of justice that after a business provides a detailed written appeal to the IRS of an auditor's decision, that auditor can engage in unlimited discussion of the taxpayer's case with the IRS Appeals Office. Yet, this can and does happen often. It is justified by the

IRS as a way for the Appeals Office to "tap into" the expertise of an auditor in cases like employment tax audits that are often fact-intensive and involve an ambiguous 20-factor test.

We must stop these private consultations.

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As I mentioned earlier, there are many other employment tax procedures that should be changed. But I would now like to turn to the substantive legal standards for classifying a worker -- standards that must be applied even if procedural changes are made.

II. Substantive Standards

NACCB believes that fundamental substantive changes to our employment tax laws are required. In particular:

A. We support H.R. 1972, introduced by Congressman Christensen, co-sponsored by almost 120 House Members, and endorsed by NFIB and an over-whelming number of associations. This bill offers a sound legal standard to determine who is an independent contractor for the 21st century.

B. We support parts of H.R. 582, introduced by Congressman Kim, that would (1) repeal Section 1706 of the 1986 Tax Reform Act (which exists as Section 530(d) of the 1978 Revenue Act, as amended); (2) eliminate unreasonably narrow IRS interpretations of Section 530; and (3) improve tax compliance by substantially requiring Form 1099 payments to be listed on service recipient tax returns.

C. We support steps to assure even greater tax compliance, including (1) significantly increasing the penalties for non-issuance of IRS Forms 1099, e.g. up to amounts up to 5% of compensation required to be reported on such forms, with exceptions for de minimis instances of non-issuance or erroneous reporting; (2) restricting the "prior audit" safe haven in Section 530 to only "prior employment tax reviews", which would include reviews of worker status (whether done in the context of a separate employment tax audit, income tax audit, etc.), but which would not include income tax audits or other audits in which worker status was not reviewed and evaluated by the IRS; and (3) in appropriate instances, requiring IRS Forms 1099 to be issued in connection with payments to corporations for personal services.

A. H.R. 1972

NACCB strongly supports H.R. 1972, the bill introduced by Congressman Christensen and co-sponsored by almost 120 House Members. This bill provides a proper test of who is not an employee that can take us into the 21st century. It recognizes that both blue-collar and white-collar workers should

have a fair opportunity to offer their services as independent contractors.

Of greatest importance to us, the bill accommodates the growing class of "knowledge workers" -- like computer consultants, engineers, financial consultants, management consultants -- whose major investment is not in a truck or a set of tools, but in the extensive training and continuing education in their professional fields. These self-employed workers -- particularly the ones who choose to complete special projects for a client that may last a year or longer -- should not lose their independent status as long as they continue to treat themselves as businesses through advertising, trade name registration, or similar means. Businesses should be allowed to retain the services of these self-employed workers without fear that the IRS will reclassify them because the project lasted too long or the worker voluntarily chose to focus all or his or her energy on this one project and declined to accept other consulting arrangements from other clients.

To the extent that H.R. 1915 has been criticized by a few as too complicated, we believe that the bill has been misunderstood. Congressman Christensen himself in last week's testimony to this Subcommittee explained that his bill has a simple, three-part test to determine worker status. Significantly, although there are many alternatives by which each of these three parts can be met by a taxpayer, only one alternative need be met under each part. Providing several available choices is a key benefit of this bill, and far from being a point of criticism, it should generate support.

B. H.R. 580

We support Congressman Kim's effort to reform Section 530. Most strongly, as included in Congressman Kim's bill, we urge Congress to repeal Section 1706 of the 1986 Tax Reform Act, also known as Section 530(d) of the 1978 Revenue Act, as amended. A broad consensus has evolved to repeal Section 1706 since uniquely it leaves the high-tech industry as the only industry in the United States without any employment tax safe haven. This discrimination can no longer be justified. Attached to this testimony as Attachment A is a statement from the Coalition to Repeal Section 1706.

As to other proposed changes to Section 530, as outlined in H.R. 582, we have previously commented on many of these proposals as part of our testimony on July 23, 1992 before the Subcommittee on Select Revenue Measures of the House Ways & Means Committee, at hearings entitled "Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes", Serial 102-125, at pages 266 - 277. We will not repeat that testimony here. However, one point not addressed in our earlier testimony, and which we

support as part of H.R. 582, is the requirement that taxpayers list Form 1099 income on their returns.

While we also appreciate Congressman Kim's effort to arrive at a simple alternative test of who is an independent contractor -- apart from Section 530 -- we believe that in this regard his bill has been superseded by H.R. 1972. In fact, we have some concern that the substantive standard in H.R. 582 would be of limited value to self-employed computer and engineering consultants and the businesses which use their services; H.R. 1972 is far more preferable in this regard.

C. Other Reforms

In our testimony on July 23, 1992 before the Subcommittee on Select Revenue Measures of the House Ways & Means Committee, at hearings entitled "Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes", Serial 102-125, at pages 266 - 277, we suggested ways to further increase tax compliance by increasing non-reporting penalties, narrowing the "prior audit" rule in Section 530, and extending Form 1099 reporting responsibilities in appropriate circumstances to payments to corporations for services. We will not repeat our earlier testimony here.

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We thank the Subcommittee for entertaining our testimony and look forward to working with you in developing your recommendations.

Attachment to August 2, 1995 testimony of NACCB before House Subcommittee on Taxation and Finance of the Small Business Committee

Before the

Ways and Means Committee

United States House of Representatives

July 11, 1995

Testimony of

COALITION TO REPEAL SECTION 1706[1]

in support of proposal to

Repeal Section 1706 of the 1986 Tax Reform Act

We are the representatives of small business entrepreneurs, who own or manage over ten thousand software, engineering, data processing and technical writing companies throughout the United States -- including many thousand that are minority and/or women-owned. We are delighted that Congress is finally moving to repeal of Section 1706 of the 1986 Tax Reform Act -- an employment tax law which on its face discriminates against America's high technology industry and has a particularly adverse effect on small business as well as minority and women entrepreneurs in our industry. Congress has begun to see, more clearly than in the past, the need to help small business, and to encourage entrepreneurship in our high-tech industry; as a coalition representing both constituencies, we ask for your support and leadership now.

We will not attempt, in this short statement, to explain all the details of our problem. Instead we are providing attachments with this letter. These attachments show that because of Section 1706, the technical services industry is the only industry in the United States that does not have the "employment tax safe haven" protection of Section 530 of the 1978 Revenue Act, or any other alternative "safe haven". Instead, pursuant to Section 1706 our employment tax obligations are governed only by the vague and unpredictable 20 question common law test -- the very test for which Section 530 was enacted as a safeguard from the common law test's frequently capricious effects. These effects of Section 1706 are felt most adversely by new market entrants. Why? Because the common law test emphasizes a lengthy history of entrepreneurship, large capital investment, several concurrent customers, advertising and other factors that are more difficult for many newly self-employed independent consultants to meet. In addition all self-employed high-tech professionals have faced far fewer consulting opportunities as businesses are fearful to use their services because of Section 1706.

Every independent analysis of Section 1706 -- including the Treasury Department, the House Government Operations Committee, the American Tax Policy Institute, and ComputerWorld (the leading publication for the computer industry) -- has found Section 1706 to contain unreasonable and discriminatory provisions.

If we really want to promote America's high-technology industry and restore tax fairness, then the repeal of Section 1706 should be included in the upcoming tax bill.

For more information Coalition to Repeal Section 1706
1250 Connecticut Ave, N.W. - Suite 700
Washington, D.C. 20036
(202) 637-6483

1 Members of the Coalition include American Consulting Engineers Council; Black Data Processing Associates, Computer Software Industry Association, Data Processing Management Association, Design Professionals Coalition; Independent Computer Consultants Association, Information Systems Consultants Association, Institute of Electrical and Electronics Engineers, Inc -- United States Activities, National Association of Computer Consultant Businesses, National Association of Women Business Owners, National Writers Union, Professional & Technical Consultants Association, Software Forum, and Technical Consultants National Association

Statement of

Marshall V. Washburn
National Director, Specialty Taxes
Internal Revenue Service

Before the

Subcommittee on Taxation and Finance
House Committee on Small Business

The Administration of Employment Taxes

August 2, 1995

STATEMENT OF
MARSHALL V. WASHBURN
NATIONAL DIRECTOR, SPECIALTY TAXES
INTERNAL REVENUE SERVICE

BEFORE THE
SUBCOMMITTEE ON TAXATION AND FINANCE
HOUSE COMMITTEE ON SMALL BUSINESS

THE ADMINISTRATION OF EMPLOYMENT TAXES

AUGUST 2, 1995

MADAME CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I AM PLEASED TO REPRESENT COMMISSIONER RICHARDSON AND TO TESTIFY ON BEHALF OF THE INTERNAL REVENUE SERVICE ON THE ADMINISTRATION OF EMPLOYMENT TAXES. DURING THE COURSE OF MY TESTIMONY TODAY, I WILL BE ANNOUNCING TWO IMPORTANT CHANGES TO THE EMPLOYMENT TAX PROGRAM RELATIVE TO THE ISSUE OF WORKER CLASSIFICATION.

INTRODUCTION

THE IRS HAS BEEN WORKING TO IMPROVE TAX ADMINISTRATION FOR ALL TAXPAYERS INCLUDING THOSE WHO ARE SMALL BUSINESS OWNERS. IN MARCH 1994, COMMISSIONER RICHARDSON ESTABLISHED THE SMALL BUSINESS AFFAIRS OFFICE TO WORK WITH SMALL BUSINESS OWNERS TO ADDRESS ISSUES

CROSSING INDUSTRY AND GOVERNMENT AGENCY LINES. THE COMMISSIONER HAS APPOINTED BARBARA JENKINS TO HEAD UP THIS OFFICE.

WITHIN THE LAST SEVERAL MONTHS, COMMISSIONER RICHARDSON ACCOMPANIED BY OTHER IRS REPRESENTATIVES CONDUCTED A SERIES OF SIX "TOWN MEETINGS" WITH SMALL BUSINESS OWNERS ACROSS THE COUNTRY- - FROM SEATTLE, WASHINGTON TO MANCHESTER, NEW HAMPSHIRE TO LAS CRUCES, NEW MEXICO. SMALL BUSINESS PARTICIPANTS MADE NUMEROUS THOUGHTFUL SUGGESTIONS AT THESE MEETINGS FOR IMPROVEMENT THAT THE IRS IS REVIEWING.

THE COMMISSIONER ALSO PARTICIPATED IN THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS. AT THIS CONFERENCE, THE PARTICIPANTS IDENTIFIED WORKER CLASSIFICATION AS THEIR NUMBER ONE CONCERN. WORKER CLASSIFICATION IS ALSO A SIGNIFICANT ISSUE IN THE INTERNAL REVENUE SERVICE'S ADMINISTRATION OF EMPLOYMENT TAXES.

THE COMMON-LAW STANDARD

UNDER THE INTERNAL REVENUE CODE, WHETHER A WORKER IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR IS DETERMINED USING THE COMMON-LAW STANDARD. THIS STANDARD LOOKS TO WHETHER A BUSINESS

HAS THE RIGHT TO DIRECT AND CONTROL THE MEANS AND DETAILS OF THE WORKER'S ACTIVITIES.

APPLYING THIS STANDARD HAS BEEN DIFFICULT FOR BOTH TAXPAYERS AND FOR OUR AGENTS. MANY YEARS AGO, TO HELP OUR AGENTS IN THIS TASK, WE DEVELOPED TRAINING MATERIALS THAT LISTED FACTORS THAT COURTS HAD USED. THESE ARE THE SO-CALLED "20 COMMON LAW FACTORS". THEY WERE DESIGNED AS A CHECKLIST FOR AGENTS TO USE IN IDENTIFYING WHICH FACTORS MIGHT BE RELEVANT AS EVIDENCE OF THE RIGHT TO DIRECT AND CONTROL IN SPECIFIC CASES.

I WOULD LIKE TO EMPHASIZE THAT THE 20 FACTORS DO NOT ANSWER THE QUESTION OF WHETHER A WORKER IN ANY SPECIFIC BUSINESS SITUATION IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR. TO DO SO, THE BUSINESS PERSON OR OUR EXAMINER MUST FIRST DETERMINE WHAT FACTORS ARE RELEVANT TO THE BUSINESS AT ISSUE. THEN THEY MUST DETERMINE WHICH FACTORS ARE MOST IMPORTANT. FINALLY, THEY MUST CONSIDER WHETHER OTHER FACTORS MIGHT BE RELEVANT. OBVIOUSLY, THIS LACK OF A CLEAR AND OBJECTIVE STANDARD CAUSES PROBLEMS BOTH FOR SMALL BUSINESS AND FOR OUR EXAMINERS AS WELL.

SECTION 530 OF THE REVENUE ACT OF 1978 MUST ALSO BE APPLIED BY OUR EXAMINERS. THIS SECTION PROVIDES TAXPAYERS WITH RELIEF FROM RECLASSIFICATION IF THEY HAVE PROVIDED REQUIRED FORMS 1099, HAVE TREATED A CLASS OF WORKERS AS INDEPENDENT CONTRACTORS ON A CONSISTENT BASIS, AND RELIED ON SOME REASONABLE BASIS FOR NOT TREATING THE WORKERS AS EMPLOYEES. IN ADDITION, SECTION 530 PRECLUDES THE SERVICE FROM ISSUING REGULATIONS AND PUBLISHED RULINGS ABOUT WORKER CLASSIFICATION.

OVER THE LAST SEVERAL MONTHS, WE HAVE BEEN WORKING TO IDENTIFY ACTIONS THAT WE CAN TAKE ADMINISTRATIVELY TO ADDRESS CONCERNS IN THE SMALL BUSINESS COMMUNITY ABOUT WORKER CLASSIFICATION ISSUES. MADAME CHAIRMAN, TODAY, I WOULD LIKE TO DESCRIBE TWO IMPORTANT INITIATIVES IN THE EMPLOYMENT TAX AREA ANNOUNCED BY COMMISSIONER RICHARDSON THAT HAVE RESULTED FROM THIS REVIEW.

ANNOUNCEMENT OF CHANGES TO THE EMPLOYMENT PROGRAM

WE HAVE HEARD CONCERNS FROM THE SMALL BUSINESS COMMUNITY REGARDING INCONSISTENT AND INCORRECT APPLICATION OF WORKER

CLASSIFICATION STANDARDS BY IRS EXAMINERS. TO ADDRESS THIS CONCERN, EFFECTIVE IMMEDIATELY, THE IRS NATIONAL OFFICE WILL REVIEW AND APPROVE ALL PROPOSED LOCAL COMPLIANCE PROJECTS INVOLVING WORKER CLASSIFICATION ISSUES IN A MARKET SEGMENT OR GEOGRAPHICAL AREA. THIS INCLUDES PROJECTS WHERE THE ISSUE IS THE EXISTENCE OF AN EMPLOYER/EMPLOYEE RELATIONSHIP AS WELL AS THOSE WHERE THE ISSUE IS THE IDENTITY OF THE EMPLOYER, FOR EXAMPLE, EMPLOYEE LEASING. WE ARE TAKING THIS ACTION BECAUSE THESE PROJECTS OFTEN INVOLVE AN ENTIRE INDUSTRY AND WE WANT TO ENSURE UNIFORM TREATMENT OF ALL AFFECTED TAXPAYERS. THESE PROJECTS MAY ALSO INVOLVE DIFFICULT TECHNICAL ISSUES, THE RESOLUTION OF WHICH MAY REQUIRE INPUT FROM NATIONAL OFFICE STAFF. THIS REVIEW WILL ALSO ENSURE THAT ANY PROPOSED PROJECT INVOLVING WORKER CLASSIFICATION FOCUSES ON SERIOUS DEFICIENCIES SUCH AS LACK OF INFORMATION REPORTING OR FAILURE TO PAY OVER WITHHELD TRUST FUND TAXES. IN ADDITION, NATIONAL OFFICE APPROVAL WILL ENSURE THAT PROJECT MEMBERS SEEK INPUT FROM BUSINESS PEOPLE IN THE AFFECTED INDUSTRY, AND THAT ALL PROJECT MEMBERS HAVE BEEN TRAINED IN THE FAIR AND IMPARTIAL APPLICATION OF THE EXISTING STATUTORY SCHEME OF WORKER CLASSIFICATION.

THE IRS HAS ALSO RECEIVED CRITICISM THAT SOME EXAMINERS DO NOT APPROACH WORKER CLASSIFICATION ISSUES IN A FAIR AND CONSISTENT

MANNER AND DO NOT PROPERLY APPLY SECTION 530 OF THE REVENUE ACT OF 1978. TO ADDRESS THIS CONCERN, BY JANUARY 1996, ALL IRS EXAMINERS HANDLING WORKER CLASSIFICATION CASES WILL RECEIVE ADDITIONAL TRAINING. THE TRAINING WILL REINFORCE THE IRS' LONG-HELD POSITION THAT USING INDEPENDENT CONTRACTORS CAN BE A LEGITIMATE BUSINESS PRACTICE THAT WILL NOT BE CHALLENGED BY THE SERVICE. AS PART OF THE TRAINING, EXAMINERS WILL GET EXPERIENCE THROUGH CASE STUDIES OF HOW THE COMMON-LAW TEST OF RIGHT TO DIRECT AND CONTROL THE MEANS AND DETAILS OF A WORKER'S SERVICES SHOULD BE APPLIED. THE TRAINING WILL ALSO EMPHASIZE THE NEED BY EXAMINERS TO ACTIVELY CONSIDER AND LIBERALLY CONSTRUE THE WORKER CLASSIFICATION RELIEF PROVISIONS IN SECTION 530. TO ENSURE THAT OUR MATERIALS WILL ADEQUATELY AND EFFECTIVELY TRAIN OUR EXAMINERS ON WORKER CLASSIFICATION ISSUES, A DRAFT OF THE TRAINING MATERIALS WILL BE SHARED FOR REVIEW AND COMMENT BY THE PRIVATE SECTOR, INCLUDING SMALL BUSINESS, BEFORE THE TRAINING IS INSTITUTED.

STEPS IRS HAS ALREADY TAKEN TO IMPROVE THE EMPLOYMENT TAX PROGRAM

WE HAVE ALREADY REEXAMINED OUR APPROACH TO EMPLOYMENT TAX ADMINISTRATION LOOKING FOR NEW AND INNOVATIVE STRATEGIES TO

INCREASE COMPLIANCE WITHIN THE EXISTING STATUTORY FRAMEWORK. I WOULD LIKE TO TAKE THIS OPPORTUNITY TO REVIEW FOR THE SUBCOMMITTEE SOME OF THE STEPS WE HAVE RECENTLY TAKEN TO IMPROVE OUR EFFORTS IN THIS AREA.

THE EMPLOYMENT TAX OFFICE

AT THE NATIONAL LEVEL, ABOUT 18 MONTHS AGO, THE IRS CREATED THE OFFICE OF EMPLOYMENT TAX ADMINISTRATION AND COMPLIANCE UNDER THE NATIONAL DIRECTOR FOR SPECIALTY TAXES. THIS OFFICE PULLS TOGETHER STAFF FROM THE OFFICES OF EXAMINATION, COLLECTION, AND EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS TO IMPROVE THE COORDINATION AND FOCUS OF EMPLOYMENT TAX ISSUES. THE OFFICE DEVELOPS AND OVERSEES ALL EMPLOYMENT TAX COMPLIANCE PROGRAMS INCLUDING THE EMPLOYMENT TAX EXAMINATION PROGRAM.

THE SUBCOMMITTEE HAS ASKED US TO SUPPLY STATISTICAL INFORMATION CONCERNING WORKER RECLASSIFICATION. UNFORTUNATELY, THE IRS' CURRENT INFORMATION SYSTEMS DO NOT ENABLE US TO TRACK COMPLIANCE RESULTS BY ISSUE. THUS, WE CANNOT CURRENTLY PROVIDE THE SUBCOMMITTEE WITH DATA ON ASSESSMENTS AND COLLECTIONS RESULTING FROM COMPLIANCE ACTIVITIES WHERE WORKER RECLASSIFICATION OR LIABILITY FOR SELF-EMPLOYMENT TAX WAS AN ISSUE. THE IRS IS IN THE

PROCESS OF MODERNIZING OUR TAX INFORMATION SYSTEMS. TAX SYSTEMS MODERNIZATION (TSM) IS A MASSIVE UNDERTAKING THAT WILL TAKE SEVERAL YEARS TO IMPLEMENT, BUT ONE OF ITS BENEFITS WILL BE THE ABILITY TO TRACK COMPLIANCE RESULTS BY ISSUE. WE WOULD WELCOME THE SUPPORT OF TSM BY THE SUBCOMMITTEE.

CONSOLIDATION OF THE SS-8 PROGRAM

ALONG WITH THE TRAINING PROGRAM DISCUSSED ABOVE, THE IRS IS ALSO ENSURING THE CONSISTENT TREATMENT OF SIMILARLY SITUATED TAXPAYERS BY CONSOLIDATING THE PROCESSING OF FORMS SS-8 AT TWO SITES. CURRENTLY, ONE OF THE WAYS TAXPAYERS RESOLVE DOUBTS ABOUT A WORKER'S STATUS IS TO REQUEST A PRIVATE RULING FROM THE IRS, USING A FORM SS-8. IN THE PAST, REQUESTS ON FORM SS-8 WERE PROCESSED IN EACH OF THE IRS' DISTRICTS. HOWEVER, THE DIFFICULTY IN APPLYING THE COMMON-LAW RULES SOMETIMES RESULTED IN INCONSISTENT TREATMENT OF SIMILARLY SITUATED TAXPAYERS. WHEN THE CONSOLIDATION IS COMPLETED, HOWEVER, RULING REQUESTS WILL BE PROCESSED BY TEAMS OF EXPERIENCED EMPLOYEES WHOSE SOLE JOB IS TO REVIEW FORMS SS-8. IN ADDITION TO ENSURING CONSISTENT TREATMENT, THIS APPROACH WILL RESULT IN FASTER AND BETTER SERVICE TO OUR CUSTOMERS.

MARKET SEGMENT UNDERSTANDINGS

THE MARKET SEGMENT UNDERSTANDING (MSU) PROGRAM IS A NEW AND INNOVATIVE APPROACH TO RESOLVING SOME LONG STANDING DISAGREEMENTS WITH VARIOUS INDUSTRIES. MSUS OFFER THE IRS AND INDUSTRY A NEW TOOL TO RESOLVE WORKER CLASSIFICATION ISSUES.

AN MSU FOCUSES ON A PARTICULAR AREA OF NONCOMPLIANCE WHERE THE FACTS OR THE APPLICATION OF THE LAW IS UNCLEAR, OR WHERE NONCOMPLIANCE IS WIDESPREAD WITHIN AN IDENTIFIED MARKET SEGMENT. THE MSU PROCESS IS UNIQUE BECAUSE IT USES A WORKING GROUP OF BOTH IRS AND INDUSTRY REPRESENTATIVES TO DISCUSS AND REACH A MUTUAL UNDERSTANDING OF THE FACTS CHARACTERISTIC OF THE INDUSTRY AND HOW THE LAW APPLIES TO THOSE FACTS. THE DESIRED OUTCOME OF THE MSU PROCESS IS THE ISSUANCE OF A GUIDELINE DOCUMENT THAT PROVIDES CLARIFICATION OF THE ISSUE, OR OF A PRO FORMA ACCORD. MSU GUIDELINES ARE HELPFUL TO EXAMINERS AS WELL AS TAXPAYERS AND THEIR REPRESENTATIVES.

THE FIRST MSU COMPLETED UNDER THE PROGRAM ADDRESSED THE CLASSIFICATION OF WORKERS IN THE TELEVISION COMMERCIAL PRODUCTION AND PROFESSIONAL VIDEO COMMUNICATION INDUSTRIES. THIS MSU WAS IN THE FORM OF GUIDELINES THAT HAVE BEEN USED BY OUR EXAMINERS AS

WELL AS BUSINESSES IN THE INDUSTRY.

ON JUNE 1 OF THIS YEAR, MEMBERS AND REPRESENTATIVES OF THE FOOD SERVICE INDUSTRY AND THE IRS ENTERED INTO AN AGREEMENT KNOWN AS THE TIP REPORTING ALTERNATIVE COMMITMENT (TRAC) TO INCREASE THE COMPLIANCE OF TIPPED EMPLOYEES IN THE FOOD AND BEVERAGE INDUSTRY. TRAC IS A PRO FORMA AGREEMENT ENTERED INTO ON AN INDIVIDUAL BASIS BY FOOD AND BEVERAGE EMPLOYERS. SO FAR, APPROXIMATELY 3,000 ESTABLISHMENTS HAVE SIGNED ON TO TRAC. AS A RESULT OF TRAC, IRS EXPECTS THE AMOUNT OF TIP INCOME REPORTED ANNUALLY TO INCREASE FROM BETWEEN $3 BILLION TO $5 BILLION.

OTHER PROJECTS ADDRESSING THE ISSUE OF WORKER CLASSIFICATION WITHIN DIVERSE INDUSTRY MARKET SEGMENTS ARE UNDER WAY IN DISTRICTS THROUGHOUT THE NATION INCLUDING:

- PHYSICAL THERAPISTS
- LIMOUSINE DRIVERS
- TRUCKER/MOVERS
- HOME DELIVERY SERVICE
- DRYWALL CONTRACTORS

CONCLUSION

AS PART OF ITS OVERALL GOAL OF HELPING SMALL BUSINESS, THE INTERNAL REVENUE SERVICE IS TAKING STEPS TO ENSURE THAT WORKER CLASSIFICATION PROJECTS ARE PROPERLY FOCUSED AND THAT OUR EXAMINERS ARE THOROUGHLY TRAINED IN THE CORRECT APPLICATION OF THE COMMON-LAW STANDARD AND SECTION 530 OF THE REVENUE ACT OF 1978. THIS CONCLUDES MY PREPARED STATEMENT, MADAME CHAIRMAN. WE WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU MIGHT HAVE.

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Statement of

Michael A. Wolyn

on behalf of

The Bureau of Wholesale Sales Representatives and
The International Home Furnishings Representatives Association

before the

Subcommittee on Taxation and Finance
Committee on Small Business
United States House of Representatives

INDEPENDENT CONTRACTOR/EMPLOYEE CLASSIFICATION

August 2, 1995

Madam Chairwoman and members of the Committee, my name is Michael Wolyn, and I am the Executive Director of the Bureau of Wholesale Sales Representatives, a national organization of 7,000 independent apparel and footwear sales representatives. I also speak on behalf of the 3,500 members of the International Home Furnishings Representatives Association.

The issue of worker classification is near and dear to our hearts, and I want to commend and thank the Committee for addressing it.

I can discuss some specific reclassification cases with the Committee upon request, but for purposes of my brief testimony, I am going to focus mainly on the language of H.R. 1972 and H.R. 582.

Each bill would achieve the important goal of clarifying the relationship between manufacturer and sales representative. Going beyond the 20-factor test currently used by IRS to determine classification is a great step forward that will eliminate the confusion that occurs on behalf of manufacturers who make use of independent reps.

The 20-factor test is far too arbitrary, and in many cases has been utilized to reclassify sales representatives despite the fact that they work on behalf of several different manufacturers, set their own work schedules, have substantial investments in business equipment, and are paid primarily by commission. It is reasonable to expect a principal to offer some degree of input into the methods a sales representative employs to promote its lines of merchandise, but these marginal levels of input should not be construed to constitute a significant level of control over the sales rep. Under current law, that is sometimes the case. Again, the definitions of an independent contractor under either of the bills in question would be a far more effective test.

The greatest concern of the 10,000 independent business persons I represent, is in the protection and fortification of the safe harbor protections currently found in Section 530.

Sales representatives participate in many trade shows in different cities. A women's apparel rep may participate in as many as 30 trade shows, each of a duration of 3-5 days, in a given year.

The sales representative often recruits assistance during these trade shows: someone to profile product lines, do paperwork, or model merchandise. It has been the longstanding practice within the industries I represent to treat this casual labor as independent contractors.

Increasingly, however, the Internal Revenue Service has reviewed the relationships between sales representatives and their show help, and has reclassified that help as employees. The committee is well aware, I'm sure, of the back taxes, penalties and interest that may result from a reclassification.

Recent efforts to reclassify workers has created an atmosphere of paranoia at many trade shows. Sales representatives have heard the horror stories of a Mignon Shapiro, an Atlanta-based rep for whom reclassification of show help meant going out of business. They know the story of an Arnold H., another rep, whose reclassification case could cost upwards of $50,000. Because his appeal is pending, he's unwilling to have his full name used in a public hearing, but he would be happy to speak to any member of this Committee personally.

The IRS has increasingly refused to acknowledge the safe harbor protections of Section 530 within our industries, despite affidavits from our association confirming that it is the longstanding practice to treat show help as independent, and despite the fact that such classification is prevalent in virtually every apparel and home furnishings mart in America. IRS' frequent response has been that there is thus a long history of misclassification that should be corrected. This position simply ignores the safe harbor protection of Section 530.

When a sales representative is audited for classification, and is found to have misclassified workers, he has two main options: to pay the resulting back taxes and penalties, or to challenge the ruling. The reality is that most of these small business persons do not have the resources required to take such an appeal all the way to the U.S. Tax Court.

It is not clear to me that the show help or casual labor that I have described would be protected as independent contractor help under the definitions of same in either the Christensen or the Kim bills.

For these reasons, I would suggest that H.R. 582 contains some very important wording that is absent in H.R. 1972 pertaining to the maintenance of safe harbors and somewhat more lenient guidelines for establishing safe harbor protection. Congressman Kim has done a favor to thousands of small business persons by continuing the safe harbor protection and by defining a "significant segment" of an industry as not requiring the practice by more than 25 percent of those engaged in the practice.

We acknowledge the need for greater enforcement of the requirement to file 1099s for casual labor, to enhance compliance. And we agree that the parties to an independent contractor relationship should document that relationship in writing. But we also feel that the continued use of independent contract labor for trade shows is good for small business and good for the workers involved as well. We hope that opportunity can be clarified and maintained.

I would urge the Committee to include in any legislation on this issue the maintenance of the safe harbor protection and a definition, or guideline, for establishing that protection. I again thank you for the opportunity to address you, and I will try to answer any questions the Committee may have for me.

The White House
Conference on Small Business

Foundation for a New Century

Hearing on the subject of

Clarifying the Status of Independent Contractors

Statement Before The Committee On Small Business

Subcommittee On Tax And Finance

United States House Of Representatives

Prepared by
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and

Taxation Co-Chair of Eastern Region Implementation Team

for the

Delegates to the White House Conference on Small Business

August 2, 1995

The Honorable Linda Smith, Chair
Subcommittee on Taxation and Finance
Committee on Small Business
104th Congress of the United States
House of Representatives
B-363 Rayburn House Office Building
Washington, D. C. 20515

Madam Chair Smith,

It was a pleasure to meet you and to have the opportunity to discuss an issue that is very important to me and to the small business community. I am pleased to know that it is of great interest to you as well. This opportunity to provide my statement on the INDEPENDENT CONTRACTOR issue is indeed an honor and is sincerely appreciated. It is encouraging that this issue is receiving such timely action from your committee.

I am writing from several vantage points. First, I am the owner of a small business, an accounting, tax and small business consulting company. I have operated this business on a part-time basis for more than fifteen years. I recently began a full time operation after having been an employee of a fortune top-ten company for twenty-six years. I hold two degrees in Accounting, have specialized certificates in tax and accounting subjects, earn 16 -24 CPE credits each year, and have combined twenty years experience in Corporate Accounting, Federal Taxes (domestic and foreign) and Corporate Finance. I have no employees.

At some point in the future, I plan to have employees but for now, if and when I secure jobs that I cannot personally complete, I must use the services of an independent contractor. I market my accounting and business consulting services as an independent contractor. As an independent contractor, I have been adversely affected by the twenty factors test as it now stands and is administered by the Internal Revenue Service. (Revenue Ruling 87-41 defines a twenty-factor control test based on common law principles.)

Just recently, I was put in the position of having to severe a contract before term because a non-profit organization's board of directors, acting out of fear that I may later be reclassified as an employee, insisted that I sign a legal document which went considerably beyond what was reasonable, practical or necessary for the scope of the job. It seems that several board members who happen to be attorneys became vaguely aware of the 20 factors test. They reacted rather strongly and to my detriment. Since I did not want to become their employee nor did I want to sign my rights away in order to complete the contract, I requested mutual consent to end the relationship. A written document (contract) had

already been executed which was quite competent to established my position as an independent contractor. In accordance with current law, a reasonable basis existed for not treating me as an employee. We chose to end the relationship two months early. They suffered and so did I. I could not dispute that reclassifications would not lead to costly tax bills and I could not assure that, upon audit, a reclassification would not occur, as the random determination would be up to the discretion of an Internal Revenue Service agent.

Due to the nature of the work that I am educated, trained and skilled to perform, I am best able to provide my services to small business clients as an independent contractor. As an accountant and business consultant, I must maintain principles of independence of thought and action. The small business clients whom I service are small or micro businesses, start-ups or sometimes just people with flourishing ideas. They cannot afford to hire me as an employee nor do I want to give up the control and independence required to competently complete certain types of jobs.

For instance, in providing financial statements that accurately reflect the financial health of the client, I am not burdened by the compromises and conflicts that might beset an employee. In areas where conflict may arise, for example, are concepts such as asset valuations, inventory pricing or calculations of depreciation and expense. The small business clients who need my services the most cannot afford the expense of administrative fees attached to payroll withholding requirements or the additional cost of payroll administration. This adds to the burden of the independent contractor because an increase would be required in pricing the services.

My second point of perspective comes from having served for the past ten years as a member of the IRS cadre of instructors who provide workshops and teach outreach sessions. I taught the SMALL BUSINESS TAX WORKSHOPS. A major segment of those workshops question how to make the determination of an employee versus an independent contractor. The current law addresses the question "who is an employee?" rather than "who is an independent contractor?". This is a north-south focus on the issue, when what is required is a reverse point of view. In other words, let's first clearly determine who is an independent contractor, then anyone else must be an employee.

At the present time, the IRS seems to favor any classification to employee rather than to independent contractor. This is usually an economical decision. The fines and penalties are revenue producers but have not led to increased compliance.

My third point of view comes from the many months of work that preceded the White House Conference on Small Business. I served as New Jersey's state Co-Chair of the Tax Committee. Many small business people were interviewed and the independent contractor issue was discussed at great length. Business people shared many horror stories of what had happened to them or other owners during audits and reclassifications. Some were put out of business as a result of the assessment of fines and penalties due to incorrect classifications even when fraudulent intent was not present.

At the National White House Conference on Small Business, the top sixty issues deemed to be of extreme importance to the small business community included eleven tax issues. The one conference issue to receive the most votes of all sixty was the issue of redefining an independent contractor (over 1400 votes). This is the voice of small business.

My fourth point of view, comes from the recognition that this issue, not only received the most votes of the White House Conference on Small Business, but this issue was also the top tax issue of over four hundred delegates who comprised the Minority Delegates Caucus. I served as the Tax Issues Director of the Minority Delegates Caucus. Independent contractors was a top tax issue on the agenda of the National Association of Women Business Owners (NAWBO) of which I am an active member. Of all small business owners who are independent contractors or who use independent contractors the most, a very high percentage consists of minority and women owned businesses. A large number of displaced and downsized corporate employees became independent contractors and are comprised of a high percentage of women and minorities. This, one might also say, was due to economical reasons.

Another and fifth perspective has been brought about by my involvement in such organizations as the National Society of Public Accountants (NSPA) and the National Association of Tax Professionals (NSTP). These organizations are comprised of many small business owners who are entrepreneurs, sole proprietors, S-corporations and Limited Liability Corporations. They cannot always afford to put an expert on the payroll. So, for business problems, a solution may be sought from an independent contractor, whereas, a large corporation can afford a resident specialist on payroll. In the case of the cyclical work of the tax oriented business, employees may not be needed long enough to justify the cost benefit of setting up payroll withholding procedures.

Independent contractors are essential to the successful operation of many types of businesses. While it is a fact that this issue is of great importance to the small business world, it is equally important to the large businesses and corporations. They also use the services of many independent contractors. Independent contractors offer special skills for short term projects.

Position papers on this subject have been written by many. I will excerpt from three. 1) The National Association of Women Business Owners presents in it's journal "2020 Vision" , "Congress should recognize the legitimacy of, and clarify the definition of, an independent contractor. The following points are vital: a) the 20-factor test is too subjective, and the number of relevant factors should be narrowed. More definitive and realistic guidelines for implementation must be established for IRS auditors, courts, employers and state agencies; b) safe-harbor provisions should be established to protect the hiring business from burdensome IRS penalties. DeMinimus rules based on dollars paid, hours worked, years in business, and/or specified, closed-end projects should be established;..."

2) The National Society of Public Accountants' 1995 National Issues Conference Position Papers discussed independent contractors at length, "Current IRS interpretations of independent contractor status are generally based on employer control of the results of the work and not the means and methods of accomplishing that result. Because of the current guidelines, the classification will depend on the facts and circumstances in each case. This is very confusing for employers, who must depend on vague instructions in Circular E regarding employer "legal right to control the method and result of the services." At the same time, the employer faces penalties under IRC Section 3509 for making the wrong decision. If left to IRS to make the determination, the bias seems to be in favor of employee status, subjecting the employer to withholding and social security taxes, unemployment taxes, and liability insurance. Employers, faced with a changing workplace of computers, modems, and "employees" who work at home, want more flexibility in the treatment of employee versus independent contractor."

3) The stellar body of the AICPA presented a position paper, which I think is excellent except for several points. It is my personal belief that positions taken by the AICPA are generally more supportive of corporate America than of the small business sector. The AICPA's proposed safe harbor provision, minimum of 5% withholding is not cost efficient and the requirement to remit monthly would merely transfer the cost the small business owner. The promotion of involuntary withholding of taxes as a simple safe harbor provision would be burdensome to the small business owner.

All of the small business community is concerned with unreported income resulting from failure to file Form 1099s. These omissions translate to tax increases to all of us who attempt to comply with the law. Voluntary compliance can best be promoted by education, reduced complexity and a more friendly environment from the IRS. The IRS has in recent years made great efforts to improve it's client atmosphere.

Statistics indicate that this country is run by small and mini businesses, and what is required is to make it easier for them to comply with the income tax laws rather than to make it more difficult. The

additional burdens of requiring withholding taxes from independent contractors only encourage the development of creative ways to avoid the problem. Or it serves to punish those small businesses who jump through the hoops in an attempt to comply.

In conclusion, I do not agree with any provisions or schemes of withholding. If our system is to remain one of voluntary compliance, then we don't need to have our hands held to the fire with a five percent withholding provision or any withholding provision for that matter.

It is common consensus that a better definition of independent contractor is urgently needed. In the process of getting there, we do not want to make it more difficult for the small business person to run a profitable, viable business.

If a small business owner has made a good faith attempt to classify a worker under current common law..., and the independent contractor has filed appropriate information returns, reported income and paid tax, then penalties should be abated.

Any requirements for the filing of additional forms are not practical. The White House Conference on Small Business, in the Regulation and Paperwork issue segment, voted to reduce paperwork. It would be inconsistent to reduce paperwork in one area and increase it in another.

The many proposed solutions, including H.R. 1972, should be considered but with caution. Withholding should not even be considered and Safe Harbor provisions are absolutely necessary. Yes, safeguards that prohibit abuse of the system definitely need to be in place.

The White House Conference on Small Business asked for "realistic and consistent guidelines" with a four criteria option plus a written agreement. The criteria are: (1) realization of profit or loss; (2) separate principle place of business; (3) making services available to the general public; or (4) paid on a commission basis.

Also requested were Safe Harbor provisions, based on DeMinimis rules, and the elimination of back taxes for misclassification when Form 1099's are filed, and in the absence of fraud. (The full text has been provided).

This seems quite workable to me.

Thank you and your committee for your consideration of this matter.

Joy J. Turner, Business Owner, Piscataway, New Jersey and
Eastern Region Taxation Co-Chair for 1995 White House Conference on Small Business Implementation Team

Statement

On

"CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS"

Submitted to

THE TAXATION AND FINANCE SUBCOMMITTEE

of the

COMMITTEE ON SMALL BUSINESS

of the

U.S. HOUSE OF REPRESENTATIVES

August 4, 1995

By: Ms. Lillian Lincoln, CBSE
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On behalf of the 2,700 members of the Building Service Contractors Association International (BSCAI), I am pleased to submit, for the record, testimony regarding "Clarifying the Status of Independent Contractors."

BSCAI is an association of companies predominantly involved in the contracting of janitorial services and is incorporated as a 501(c)(6) trade association. Our headquarters are located at 10201 Lee Highway, Suite 225, Fairfax, Virginia 22030.

Your Committee, Congressmen Christensen and Kim, as well as the delegates to White House Conference on Small Business are to be congratulated for their efforts in bringing this issue to the forefront of the 104th Congress' political agenda. However, there is so much more that this Subcommittee and Congress must consider before moving forward on this issue.

For well over a decade, American small business has come before Congress seeking relief from the ill-conceived employee classification laws that have hampered a fair and competitive environment. Seeking a legislative solution that answers only the concerns of independent contractors could result in another decade of fighting for employer and worker rights.

Failing to address the legitimate concerns of law-abiding employers who, by current law and even H.R. 1972 or H.R. 580 are employees,

ignores an entire class of workers who, like independent contractors, deserve the benefit of clarification of the law that will allow their pursuit of the American dream. Employers and their workers classified as independent contractors do not have a monopoly on the entrepreneurial spirit that drives American small business.

A law-abiding building service contractor who has to lay off 4,000 workers and loses some $5 million a year to competitors who misclassify their workers as independent contractors, deserves the benefit of fair and equitable laws that protect him and his employees' pursuit of the American dream.

The issue before your committee represents one of the most pervasive problems in our industry today, the practice of employers misclassifying their workers as independent contractors.

In the building service contracting industry this practice is most often referred to as illegal subcontracting. As a result, the building service contracting industry, along with other service and construction industries, have been operating on an unlevel playing field for years. This "silent killer" is affecting an industry that, according to Department of Labor projections, by the year 2000 will create 555,000 new jobs and a total work force of 3.45 million janitors.

Congressional hearings have documented that employers who exploit the ambiguities in the employment tax laws by intentionally misclassifying workers or evading enforcement efforts under the protection of Section 530 safe harbors can severely impact the law abiding taxpayer, deprive federal and state governments of employment tax revenues, as well as the benefits that are rightfully due each and every worker in the nation.

While legitimate independent contractors are an important element of the American free enterprise, taking advantage of poorly conceived tax policy goes against the competitive spirit that is the foundation of American small business.

The misclassification issue here in the Congress and at the IRS is discussed in the context of classifying workers as "employees" or "independent contractors." In the building services industry, we refer to this issue as the "illegal subcontracting" problem. While the terminology is somewhat different, the issue is the same.

Based on our knowledge and experience of the industry, the typical cleaning company in the building services industry treats its workers as employees, not independent contractors. This is the "prevailing industry practice," certainly when viewed on a national basis.

Based on the Internal Revenue Services use of the 20 common law factors to determine whether a worker is an "employee" or an "independent contractor," we believe that under any reasonable interpretation of this test, the workers in our industry are "employees."

The misclassification problem occurs in our industry when a firm bidding for a cleaning contract does so based on "subcontracting out" the actual cleaning work to "independent contractors" (the actual workers who do the cleaning).

A firm bidding on this basis has an obvious competitive advantage vis-a-vis a firm bidding based on classifying its workers as employees. The firm "subcontracting out" the work to independent contractors does not have to concern itself with various labor burden costs, such as federal FICA, FUTA, state SUTA, worker's compensation and general liability insurance costs. The "subcontracting" firm also does not have the administrative costs associated with tax compliance for employees. This package of costs vary from state to state, but is generally in the range of twenty to thirty percent of the contract price.

The problem appears to be growing worse as more and more local markets are affected. In some states such as in Texas, California, Georgia and Florida, the "subcontracting out" practice has become

so prevalent that it may - absent action by Congress and/or the IRS - become the "de facto" prevailing industry practice in those markets. And despite building service contractors efforts to work with the Internal Revenue Service in these areas, enforcement or a lack of it has not made an impact.

Previous Congressional testimony has addressed in detail the harm done to the workers involved in misclassification. While a worker so misclassified may gain the temporary advantage of not having his or her wages subject to withholding, that worker loses a number of benefits and protections, such as worker's compensation, unemployment insurance protection, employer contributions to his or her social security, etc.

I would also add that the workers involved, at least in our industry, are often recent immigrants to the United States who are even more subject to potential abuse because of their unfamiliarity with the language and the law. Again, according to the Department of Labor, janitors and maintenance workers are the No. 1 unskilled employees in demand in the 90's. It is their pursuit of the American dream, often working at night, as a second job, that deserves to be protected.

The prior tax audit provision is our industry's nemesis. It is our understanding that a company which has undergone a prior audit is then protected for the indefinite future from IRS inquiry

concerning the classification of that company's workers. We understand this is true even if the audit was for something such as income taxes and not specifically directed to employment taxes.

We believe this "prior audit" safe harbor provision, as currently written, "rewards" a company that misclassifies its workers as independent contractors. It is unfair to competing firms. It is bad tax policy. It harms workers. It harms the federal, state and local government through lost tax revenue.

We do our workers no favor if we rob them, through misclassification as independent contractors, of worker's compensation, unemployment insurance, disability insurance, protection under the Fair Labor Standards Act, the Occupational Safety and Health Act, the American with Disabilities Act, the Family Leave and Medical Act of 1993 and protection through the Equal Employment Opportunity Commission which have been erected by the federal and state government over the past half century.

Recommendations. Congress should pass legislation that clarifies with legislative and regulatory oversight the resolve of a long standing issue that to date has handicapped the entrepreneurial spirit of the small business owner, deprived employees of benefits due them under the law, and robbed the federal and state governments of much needed revenues. Such oversight would allow the participation of all American small business employers and

their workers, whether they be independent contractors or employees.

BSCAI and its members while appreciative of the efforts behind H.R. 1972 and H.R. 580, and the attempt to protect the rights of independent contractors, ask that the rights of employees not be ignored at the expense of one class of workers or the other.

H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Congressman Tom Lantos deserves the committee's attention. Most importantly, to our industry, H.R. 510 marrows the "prior audit" safe harbor to apply only in cases of prior audits that actually consider the employment tax issue. Additional provisions in this legislation worthy of consideration include (1) allowing an amnesty period for employers to properly classify workers without a penalty, (2) removing the issuance of regulations clarifying the distinction between employees and independent contractors, and (3) provides for notification of workers of the consequences of being classified as independent contractors so they can make informed decisions about where they will work.

We support vigorous enforcement and audit action by the Internal Revenue service to ensure proper classification of workers. When appropriate under applicable law, we feel that an amnesty program for employers who have misclassified, but relied on "prior audit"

protection of Section 530 would be a positive and useful step in helping correct current cases of misclassification.

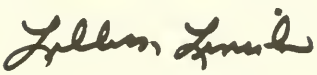
By clarifying the employment tax laws Congress has the potential to generate billions of dollars in revenues at a time when it is so desperately needed. This Congress should not expect law abiding companies to shoulder increasing financial responsibilities while competitors providing similar services are allowed to evade these responsibilities.

There are few that argue the important role that American small businesses will play in the future growth and stability of our economy. Too often our efforts to create economic growth and new jobs are interrupted by inequities of our own creation, in this case, ambiguities in the employment tax laws.

BSCAI and the Coalition for Fair Worker Classification, of which we are an active participant, and the thousands of employers and millions of workers it represents, welcome the opportunity to work with this Subcommittee, Congress, the Administration, the National Federation of Independent Business, the Small Business Legislative Council and all others in an attempt to resolve this sensitive and complex issue in a manner that will benefit ALL American small businesses. BSCAI further recommends that, this subcommittee in its recommendations to the full committee, establish a congressionally sponsored "commission" that would address this

issue in its entirety and not at the expense of employees or independent contractors.

Respectfully submitted,



Lillian Lincoln, CBSE
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STATEMENT OF THE

NATIONAL ASSOCIATION OF HOME BUILDERS

before the

UNITED STATES HOUSE OF REPRESENTATIVES

HOUSE COMMITTEE ON SMALL BUSINESS

on

CLARIFYING THE STATUS

OF INDEPENDENT CONTRACTORS

AUGUST 2, 1995

Madam Chairman and Members of the Committee:

The National Association of Home Builders (NAHB) and its 185,000 members congratulate you for holding this hearing and appreciate the opportunity to present its views. This statement will address the classification of workers as employees or independent contractors and the legislative proposals to clarify that status.

At the outset, it has long been the position of NAHB that the current law pertaining to worker classification recognizes the unique characteristics of the home building business and allows the flexibility necessary for building industry workers to function in a changing economy. Moreover, the current rules under Section 530 of the Revenue Act of 1978 provide equitable relief for taxpayers who become involved in disputes with respect to worker reclassification.

It has been our concern that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

H.R. 1972, introduced by Representative Jon Christensen would prohibit the Internal Revenue Service from classifying subcontractors as employees if certain requirements are met. Failure to maintain active compliance with Internal Revenue Code filing requirements would result in loss of the protection of the statute. H R. 1972 would replace the common law test of employment status with a more objective three-part test but would not repeal Section 530 of the Revenue Act of 1978. For the reasons set out below, NAHB supports H.R. 1972 as establishing reasonable guidelines for the protection of independent contractor status.

H.R. 582, introduced by Representative Jay Kim, would repeal Section 530 and amend the Internal Revenue Code to include a modified "safe harbor" rule. It would direct the Secretary of the Treasury or his delegate to report to Congress proposed legislation containing objective criteria to determine an individual's status as an employee. For the reasons set out more fully below, NAHB opposes H R. 582.

INDUSTRY PROFILE

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades, and because job sites necessarily change as the homes are built, the relationship between the home builder and the person who performs the different trades varies widely. Another complicating factor, principally from the standpoint of the approach the Internal Revenue Service has made to many homebuilders, is the fact that a home builder routinely does "sub-out"- that is, hire an independent contractor to perform services which may, in the minds of the IRS, constitute performance of "common labor". In those instances, the IRS often alleges that the person is an employee rather than an independent contractor. The construction of single family homes is basically the coordination of the work of as many as 18 different subcontractors.

Since the volume of work in the home building industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. In today's market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships.

During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

A builder's organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 8 percent of the medium- and large-volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships.

LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform all the operations it takes to develop land and build and market homes. According to NAHB's 1987 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work, and sell through real estate agents.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 55 percent by 1987. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 14 percent. Large-volume builders tend to subcontract a larger share of the construction cost. Builders in the South use subcontractors for a larger share of construction than builders in the Northeast, Midwest, and West.

NAHB's 1987 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment. The survey showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1987 Census of Construction indicated that residential builders subcontracted $41 billion, or 40 percent of the value of their construction receipts. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 15 different subcontractor firms.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 percent of their dollar volume to work done by

subcontractors and 5 percent subcontracted 100 percent of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials. So the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

In 1987, there were 1.4 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 342,000, had total receipts of $204 billion, while the 1.06 million establishments with no payroll had receipts of $34 billion. Out of total receipts, about 35 percent went toward the purchase of materials and supplies and another 7 percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that is equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

CONSEQUENCES OF CLASSIFICATION

Reclassification of subcontractors as employees would:

1. Add substantially to the cost of doing business of the small home builder;

2. Remove the flexibility of the owner to respond to a volatile market and seasonal conditions;

3. Shift the nature of the home building business from small business to a concentration of large firms; and

4. Would add substantially to the cost of housing driving thousands of protected buyers

out of the market.

SECTION 530 OF THE REVENUE ACT OF 1978

Congress enacted §530 of the Revenue Act of 1978 to provide relief to taxpayers involved in tax controversies. This Act provides generally that if a business: (1) did not treat an individual as an employee for any period; (2) filed all tax returns (including Forms 1099) on a basis consistent with its tax position; and (3) has a "reasonable basis" for treating the worker as an independent contractor, the government is not to raise the employment tax issue in an examination.

A reasonable basis that is acceptable under §530 includes having a case or ruling that supports the taxpayer's position, a previous IRS audit in which the independent contractor treatment resulted in no assessment, or a long-standing industry practice.

When a "safe haven" under §530 is found, a company is not subject to back taxes or penalties, or obligated in the future to withhold income taxes from contractor payments or pay employment taxes on independent contractors.

THE INDEPENDENT CONTRACTOR SIMPLIFICATION ACT OF 1995, H.R. 1972

Under H.R. 1972, introduced by Representative Jon Christensen (R-NE), in order to be classified as an independent contractor, the subcontractor must satisfy three tests.

To pass the first test, the subcontractor must satisfy one of the following:

(1) Have a significant investment in assets and/or training;
(2) Incur significant unreimbursed expenses;
(3) Agree to work for a specific time or complete a specific result, and be liable for damages for failure to perform;
(4) Be paid on a commission basis; or
(5) Purchase a product for resale.

The second test requires that the subcontractor satisfy any one of the following:

(1) Have a principal place of business;
(2) Show that he/she does not primarily provide the service in the service recipient's place of business;
(3) Pay a fair market rent for use of the service recipient's place of business; or
(4) Show that he/she is not required to perform service exclusively for the service recipient, and
    (a) has performed a significant amount of service for other persons;
    (b) has offered to perform the service for other persons through advertising, individual written or oral solicitations, listing with agencies, brokers and other referral services; or
    (c) provides service under a registered business name.

To satisfy the third test, there must be a written contract between the parties, specifying that the subcontractor is not an employee. In order to retain the protection of the statute, the service recipient must properly file all Forms 1099 or W-2. Should the subcontractor fail to file the required returns, the protection of the statute would be lost.

This legislation would protect construction industry subcontractors from misclassification as employees through the establishment of clear, easily understood, tests. Moreover, H.R. 1972 would not erode the protection of the safe harbor provisions of Section 530 of the Revenue Act of 1978.

THE INDEPENDENT CONTRACTOR TAX FAIRNESS ACT OF 1995, H.R. 582

H.R. 582, introduced by Representative Jay Kim (R-CA) would repeal Section 530 of the Revenue Act of 1978 and incorporate a modified version of the safe harbor provision into the Internal Revenue Code. Under H.R. 582, in order to be classified as an independent contractor, a subcontractor must perform services pursuant to a written contract and must (a) be able to realize a profit or loss from the services, (b) maintain a separate place of business and have a significant investment in tools or facilities, (c) make his or her services available to the general public on a regular and consistent basis and must have performed such services as a subcontractor for another service-recipient during the last two years, or (d) be paid exclusively on a commission basis and maintain a separate principal place of business (or pay fair market rent if not a separate place of business).

The written contract must state that the subcontractor will not be treated as an employee by the contractor, that the contractor is aware of the Federal tax obligations resulting from such treatment and that he/she will maintain separate accounting of income and expenses relating to the contract. If the tests are satisfied, the bill would generally relieve the contractor of employment tax liability. It would increase the penalty for failure to file Forms 1099 and require that independent contractors report each individual 1099 payment received on their income tax returns. H.R. 582 would also direct the Secretary of the Treasury to report to Congress proposing legislation which specifies objectively measurable criteria for determining whether an individual is an employee.

NAHB opposes the proposals to repeal Section 530 of the Revenue Act of 1978 and to delegate legislative authority to the Secretary of the Treasury. We note that Congress enacted Section 530 as the result of over zealous enforcement by the IRS of employment tax laws. Given the propensity of government to classify subcontractors as employees rather than independent contractors, we believe that any legislative proposal in this area must and should be generated by Congress.

Finally, NAHB fully supports the proposition that every American must pay his full share of Federal income tax. Independent contractors employed in the home construction industry generally satisfy the current 20-factor test. Increased IRS compliance activity would unveil dishonest construction contractors and level the playing field for honest construction employers. It is the job of the Internal Revenue Service to resolve the compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements. In this regard, NAHB agrees with the proposals to increase IRS enforcement efforts by increasing penalties for failure to file correct payee statements.

CONCLUSION

For the reasons set out above, NAHB supports H.R. 1972 as providing reasonable criteria to establish employment status without restricting the classification of independent contractor. NAHB opposes H.R. 582 as unduly limiting the available safe-harbor protection afforded by Section 530, although we would support increased penalties for noncompliance with the employment tax form filing requirements.

The National Association of Home Builders is much appreciative of having had this opportunity to present our views on clarifying the status of independent contractors.

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Statement
of the
National Technical Services Association
submitted to the
Subcommittee on Taxation and Finance
Committee on Small Business
U. S. House of Representatives
for the
August 2, 1995
Hearings Record

"Clarifying the Status of Independent Contractors"

I. The Issues

Madame Chairwoman and members of the Committee, the National Technical Services Association (NTSA) appreciates this opportunity to comment on worker classification proposals before your committee. We focus our comments on § 1706 of the Tax Reform Act of 1986, § 530 of the Revenue Act of 1978, and other worker classification legislation before your committee.

On August 2, your committee entertained testimony regarding a proposal to repeal § 1706. We submit that until § 530 is materially narrowed, and new employment classification guidelines are forwarded by Congress, § 1706 should not be repealed. It has restored some rationality to the worker classification issue in the technical services industry and there should be no retreat from that gain except in the case of a fresh start for all industry.

How Congress approaches the issue of worker classification in the future is a key issue which does need to be resolved. Central to any discussion involving § 1706 is first, the establishment of clear employment classification guidelines and second, striking balance between IRS enforcement, taxpayer protections, and other laws which are predicated on elements of the common law test. We note that a number of bills have recently been introduced to simplify the classification of workers for federal income tax purposes. We favor such simplification, yet caution that these efforts should not favor one classification over another.

II. About NTSA

NTSA is a non-profit organization which exists to promote the legal, legislative, regulatory, strategic business development, and continuous process improvement interests of member firms. NTSA members supply a wide range of design, drafting, engineering, project management, computer programming, systems analysis, staff augmentation, and technical publication services, for profit, to industry and government clients. Members number among their clients most major

American corporations, thousands of small industrial companies, government agencies, and colleges and universities across the United States. Our 200 corporate members operate 800 technical services offices, employ more than 280,000 technical personnel, and generate between $6 - $9 billion annually in sales of technical staffing and other support services.

III. NTSA Member Concerns

When the IRS, applying the common law test, has addressed the issue of worker classification in the technical services industry, the IRS has generally been of the view that the personnel are employees of the technical services firms for purposes of federal income, social security, and unemployment tax withholding.[1]

While NTSA has never advocated a preference for one classification over another, we have repeatedly noted that the protections afforded under § 530 had the effect of fostering and encouraging misclassification of workers in our industry through a combination of two effects. First, § 530 is frequently perceived as giving the "OK" to independent contractor classification almost as a matter of choice. Second, by limiting IRS' rule-making authority, § 530 reinforces the perception that § 530 gives carte blanche to companies and workers to choose independent contractor status if so desired. One effect feeds on the other.

In its discussion of the motivation for Congressional enactment of § 1706 which concerns technical service workers, the Treasury stated:

> "Section 530 affects different taxpayers differently, depending on whether they satisfy the conditions for relief contained therein. In particular, some taxpayers that have consistently misclassified their employees as independent contractors are entitled to relief under § 530, while other taxpayers in the same industry (that, for example, have taken a more conservative position on classification issues) are not, because they cannot satisfy the consistency requirements of the Section."[2]

The uneven playing field arising out of § 530 was the stimulus for NTSA's support of enactment of § 1706.[3] Section 1706 removed the protections offered under § 530 for firms which supply technical services. This limited exception applies only to multi-party business transactions which involve 1) firms which supply or broker the services of technical personnel, 2) technical personnel, and 3) the clients that benefit from the services of the technical personnel.[4]

Section 1706 does not change the common law rules for classifying workers as employees or independent contractors, nor does it change the employment status of anyone covered by the provision. It simply permits the IRS to interpret and enforce the underlying rules for technical services workers without regard to § 530. Remember, an employer is only entitled to § 530 relief it has, in fact, misclassified its employees as independent contractors.

The Consistency that § 1706 brought to the tax treatment of workers within the technical services industry has worked. Organizations like NTSA have communicated the tax laws effectively to their members. As a result, companies in the technical services industry have benefited due to the

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1 Rev. Rul. 87-41, 1987-1 C.B. 296; Rev. Rul. 75-41, 1975-1 C.B. 323; LTR 8552072 (Sept. 30, 1985); LTR 8324005 (technical advice memorandum, Feb. 24, 1983); Ltr 8403003 (technical advice memorandum supplementing LTR 8324005, September 22, 1983).

2 See Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, U.S. Treasury Department, March 1991, pp. 32-33.

3 P.L. 99-514, § 1706, 100 Stat. 2095, 2781 (1986).

4 Rev. Rul. 87-41, 1987-1 C.B. 296.

issuance of industry-specific classification guidelines, treated their employees in accordance with the law, and, we believe, greater awareness and tax compliance has been achieved.

IV. Policy Recommendations for the 104th Congress

Repealing § 1706 is not the answer. Simply codifying § 530 is not the answer either. That law was designed merely to maintain a status quo for a short period of time -- it was a "time-out" call intended to keep things as they were until new rules were crafted. Its safe harbors and consistency requirements were never intended as policy judgments which would endure far into the future. Clearly, Congress could not have intended to reward the "consistent" conduct of a company that aggressively misclassified its workers as independent contractors over the inconsistent conduct of a company which in good faith searched for the correct approach amidst shifting rules. Moreover, a rule that treats companies in the same industry differently based on how long a company has been in existence or based on a company's past practice is patently unfair.

A. Amend § 530 "Prior Audit Rule"

NTSA recognizes that § 1706 repeal language is present in the Misclassification of Employees Act, HR 510. If passed, this bill would institute a limited scope taxpayer amnesty program concurrent with amending § 530. Under this bill, the list of reasonable bases for treating a worker as an independent contractor would be modified to incorporate a much more contemporary application of the "prior audit" rule.[5]

NTSA would likely support repeal of §1706 if such action were concurrent with amending the prior audit rule to make it specific to "employment classification compliance checks or audits" conducted within a reasonable time frame.

B. Establish Independent Contractor and Employee Classification Safe Harbors

NTSA continues to urge Congress to provide significant guidance by setting forth a limited number of factors which employers, individual taxpayers, and the IRS may use to make worker classification determinations. These factors should be based on common law and expressed as safe harbors.

Taxpayers who fall within one of these "safe harbors" would be assured that they would not be subjected to large retroactive penalties should the employment status of their workers be questioned. Likewise, NTSA believes that if a worker disputes the classification, the worker should be able to request a ruling from the IRS based on the broader application of the 20 common law factors. This request would be made through a version of the current Form SS-8 procedure.[6]

NTSA has reviewed, with great interest, the provisions offered under the Independent Contractor Tax Simplification Act of 1995, HR 1972. Under this bill, the 20 common law factors would be replaced -- for purposes of determining who is not an employee -- by a new set of criteria which, if

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[5] See for example, HR 510 legislative summary "an IRS audit conducted solely for employment tax purposes within three years before the period in question, which audit includes an examination for employment tax purposes of workers holding substantially similar positions to the worker in question, and following which audit the employer is notified in writing by the IRS that the employer has classified the workers correctly and the IRS notification is not revoked before the period in question; or..."

[6] See "Statement of the National Technical Services Association," Hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations House of Representatives, 101st Cong., 1st Sess., June 8, 1993.

met, would allow any employer or individual to determine "selectively" whom among their labor force to class as employees and whom to class as independent contractors. There would be no requirement for consistent worker status treatment. There would be no "service recipient" tax liability as long as 1099's are properly filed, a qualifying written contract exists, and the "service supplier" meets one of 5 safe harbor requirements.

While H.R. 1972 and similar proposals represent a new, creative approach to the issue of worker classification, we suggest that, in the end, simplification can be achieved without introducing a whole new set of independent contractor criteria.

For example, we believe that worker classification objectivity would be equally achievable by simply structuring new safe harbors around key elements of the present common law test. Such safe harbors might specify that:

1) A worker is an independent contractor if:

- the worker works for several bona fide customers at any one time and, subject to agreed upon due dates, schedules the order in which the work is done; and
- the worker performs substantially all of the work at the worker's place of business, which is not furnished by the customer, or if it is furnished by the customer, for which the worker pays fair market rent; and
- the worker bears the economic risk of the business because the worker's remuneration is directly based upon output or deliverables and not upon the number of hours which the worker works.

2) A worker is an employee if:

- substantially all of the work performed by the worker is done during regular business hours at one company's (or that company's customer's) place of business; or
- the company schedules the hours (including instituting flex-time scheduling) the worker is to work; or
- the worker is paid by the hour, week or month for time worked; and
- payment for work done for one company, directly or indirectly, is the worker's sole or major source of income for the worker's services.

V. Other Considerations for Congress

The application of worker classification standards, whether in their current form, or as may be amended, however, currently focus on tax related questions. For example, under H.R. 1972, a worker may be classified as an independent contractor for tax purposes but would remain an employee under the criteria set forth in the Fair Labor Standards Act, Title VII of the Civil Rights Act, the Americans with Disabilities Act, the Family and Medical Leave Act and various state unemployment and workers' compensation laws. This dichotomy would occur because most of these laws also are principled upon elements of the common law test. When considering the adoption of a new independent contractor test, we believe the effect such a new test will have on other bodies of law must also be considered.

VI. Summary Remarks

Until § 530 is materially narrowed, and new employment classification guidelines are forwarded by Congress, § 1706 should not be repealed. It has restored some rationality to the worker classification issue in the technical services industry and there should be no retreat from that gain except in the case of a fresh start for all industry. As new worker classification proposals are forwarded, we urge Congress to consider the effects these proposals will have on the administration of other laws as well. Congress must weigh its fiscal and employment policy objectives with the understanding that a worker classified as an independent contractor for tax purposes might later successfully challenge a failure to pay premium overtime or make a claim for an uninsured work-related injury. This anomalous but very real result can only lead to more confusion and may be compounded if new employment classification standards vary materially from the present common law test.

We look forward to working with your committee and staff on these important policy issues and would be happy to furnish further supporting information.

Respectfully submitted,

Laura Mackail

Laura McGuire Mackail
Executive Director
National Technical Services Association

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

October 2, 1995

The Honorable Linda Smith
Chairwoman, Subcommittee on Small Business and Taxation
Committee on Small Business
House of Representatives
B-303 Rayburn House Office Building
Washington, DC 20515

Dear Madam Chairwoman:

This is in reply to your letter of August 31, 1995, requesting us to provide the Subcommittee with additional information concerning the Internal Revenue Service's (IRS) administration of Federal employment taxes. We appreciate the opportunity to clarify the August 2, 1995, hearing record.

The $21 billion and $30 billion income tax gap estimates in the August 2, 1995, General Accounting Office (GAO) testimony are GAO estimates, not IRS estimates. They were developed using data from the 1988 Taxpayer Compliance Measurement Program (TCMP) for individual taxpayers. Since TCMP data do not differentiate between independent contractors and other taxpayers, the GAO income tax gap estimates are not estimates for independent contractors *per se*. Instead, the GAO estimates are for "service providers" as defined by GAO. The $21 billion GAO estimate is for nonfarm sole proprietors who claimed no cost-of-goods-sold deductions on their returns. The $30 billion GAO estimate is for nonfarm sole proprietors deemed to be service providers on the basis of the principal business activity codes shown on their return.

In its testimony, GAO estimated the total tax loss for 1992 resulting from worker misclassification at $2 billion. The $2 billion estimate was projected by GAO from the results of an IRS study of 1984 tax data, SVC-1. SVC-1 estimated the 1984 tax loss attributable to employee misclassification at $1.6 billion, including $0.9 billion of individual income tax, $0.5 billion in social security taxes, and $0.1 billion in Federal unemployment taxes.

IRS informal supplier tax gap estimates are an attempt to estimate noncompliance on the part of individuals such as roadside or sidewalk vendors, moonlighting mechanics, carpenters,

plumbers, or beauticians, unlicensed child care providers, and similar individuals with informal business styles working "off the books" or "on the side". They are based on IRS consumer surveys of purchases from informal suppliers. Sixty-three percent ($13.2 billion) of the $21 billion GAO tax gap estimate and 48 percent ($14.5 billion) of the $30 billion GAO estimate are attributable to such informal suppliers. However, the $2 billion GAO estimate of the tax loss due to employee misclassification would not include an informal supplier component.

IRS is planning to conduct 153,000 income tax examinations as part of the Taxpayer Compliance Measurement Program (TCMP). In approximately 7,500 (five percent) of these cases, an employment tax examination will also be conducted in order to accurately determine the taxpayer's correct tax liability. When an income tax examiner determines the need for an employment tax examination, the income tax examiner will make a referral to an employment tax examiner. We have recently postponed the start of the TCMP income tax examinations until the beginning of December 1995. This means that TCMP employment tax examinations resulting from TCMP income tax examiner referrals will not start before February 1, 1996. As I indicated in my August 2, 1995, testimony before the Subcommittee, the supplemental training we will be giving our employment tax examiners on worker classification will be completed by January 31, 1996.

We have emphasized to our field personnel during several conferences we have conducted throughout the year that a taxpayer does not have to concede that workers are employees under the common law in order to receive relief under section 530 of the Revenue Act of 1978. Enclosed is a copy of a memorandum, dated August 7, 1995, that I sent to the IRS Regional Chief Compliance Officers and the National Director of Appeals clarifying IRS' position on this matter. This issue will also be covered in the supplemental training on worker classification we will be providing our examiners during the month of January.

It is the policy of the IRS to announce whether it will follow the holdings in significant judicial decisions which are adverse to the Government. An Action on Decision is the document

used to make such an announcement.[1] A nonacquiescence signifies that the IRS does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers.[2] However, unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not intended to serve as public guidance and may not be cited as precedent. See 1994-2 C.B. 1.

Two Actions on Decisions were issued last year concerning the employee-independent contractor issue and section 530 of the Revenue Act of 1978. In Critical Care Registered Nursing, Inc. v. United States, 776 F. Supp. 1025 (E.D. Pa. 1991), nonacq., 1994-2 C.B. 1, the IRS made a determination that nurses were employees of a corporation that contracted with acute care hospitals to provide qualified registered nurses on a temporary basis. The judge issued instructions allowing the jury to grant relief under section 530 without determining whether the nurses should be classified as employees. The jury decided that the plaintiff had a "reasonable basis" for not treating its nurses as employees under the traditional common-law rules and returned a verdict in favor of the plaintiff. In its Action on Decision relating to Critical Care, the IRS nonacquiesced in the following issues: (1) whether a taxpayer must establish entitlement to relief under section 530 by a preponderance of the evidence; and (2) whether relief is available under section 530 absent a determination of whether the workers are employees or independent contractors under the common-law standard.[3]

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[1] Announcements of the IRS' acquiescence or nonacquiescence with respect to significant adverse cases decided in the Circuit Courts of Appeal, the Claims Court, the District Courts, and the Tax Court are published in the Internal Revenue Bulletin. Additionally, the text of the Action on Decision is released to the public within 10 working days after publication.

[2] With respect to opinions of an appellate court, the IRS will generally follow the holding of the circuit court in cases appealable to that circuit due to the binding nature of that opinion in lower courts.

[3] It is the IRS' position that relief under section 530 requires a determination that the workers are either employees or independent contractors under the common-law standard. The IRS recognizes, however, that relief under section 530 is not contingent on a taxpayer's concession that the workers are employees rather than independent contractors.

The Honorable Linda Smith

In REAG, Inc. v. United States, 801 F. Supp. 494 (W.D. Okl. 1992), nonacq., 1994-2 C.B. 1, the plaintiff, a real estate appraisal firm, consistently treated all of its appraisers as independent contractors rather than as employees. The IRS contended that the appraisers were employees rather than independent contractors. The court held that the appraisers were independent contractors. In its Action on Decision relating to REAG , the IRS nonacquiesced in the following issues: (1) whether the appraisers who performed services for the plaintiff were employees of the plaintiff or independent contractors; (2) if the appraisers were employees of the plaintiff, whether the plaintiff was entitled to the industry practice safe haven under section 530(a)(2)(C); and (3) if the appraisers were employees of the plaintiff, whether the plaintiff had some other reasonable basis for treating its employees as independent contractors under section 530.

The Actions on Decisions in Critical Care and REAG were issued to provide guidance to IRS personnel working with the same or similar facts and issues. The Actions on Decisions are not intended to serve as public guidance and may not be cited as precedent by either taxpayers or IRS personnel. Pursuant to section 530(a)(2)(A), a taxpayer will be treated as having a reasonable basis for not treating an individual as an employee if the taxpayer's treatment of such individual was in reasonable reliance on "judicial precedent." Therefore, while the IRS will not follow the decisions in Critical Care and REAG when disposing of analogous cases, taxpayers are not precluded from citing the holdings and rationales set forth therein when attempting to demonstrate in their particular case reasonable reliance on "judicial precedent."

Pursuant to section 530(b), the IRS is expressly prohibited from publishing regulations or Revenue Rulings clarifying the employment status of individuals under the usual common-law rules. Thus, Congress prohibited the IRS from issuing administrative pronouncements involving the application of common-law standards to employee-independent contractor issues, but only if such pronouncements may be cited as precedent. Regulations and Revenue Rulings may be used as precedent, but Actions on Decisions may not. Additionally, the prohibition set forth in section 530(b) relates to the status of an individual as an employee or an independent contractor. While the Action on Decision in REAG addresses this issue, both the Actions on Decisions in Critical Care and REAG involve other issues concerning the interpretation and application of section 530.

The Honorable Linda Smith

Finally, from time to time the IRS may release a revised Action on Decision to reflect changed IRS position concerning an original decision. The change might arise from any number of causes, whether additional judicial decisions, agency reconsideration, legislation, etc. As part of the retraining initiative described in my testimony of August 2, 1995, the IRS is designing new training materials. In the process of developing these materials, the IRS will look at the various existing materials, including Actions on Decisions, to ensure consistent and up-to-date communications. If the IRS identifies inconsistencies in any existing materials, corrections would be made at that time. We look forward to input from the private sector, including small businesses, when we circulate a draft of the new training materials as stated in the testimony.

I hope this information is helpful to the Subcommittee in its work. If I can be of further assistance, please do not hesitate to contact me at (202) 622-5563.

Sincerely yours,

Marshall V. Washburn
National Director,
Specialty Taxes

Enclosure

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON D C 20224

AUG - 1995

MEMORANDUM FOR REGIONAL CHIEF COMPLIANCE OFFICERS
NATIONAL DIRECTOR OF APPEALS

FROM: /s/ Thomas C. Burger, Jr.
Marshall V. Washburn
National Director, Office of Specialty Tax

SUBJECT: Section 530

We have received several inquiries as a result of a congressional inquiry regarding our interpretation and application of Section 530. The issues have recently been discussed in several publications including Tax Notes Today (TNT). We would like to clarify our position in two areas.

First, a taxpayer does not have to concede that workers are employees in order to be entitled to the relief provisions of Section 530. Nor are employers required to specifically request or apply for relief. Section 530 does provide that it applies only if workers are employees. Therefore, examiners should first determine that a worker was improperly treated as an independent contractor. Once it is determined that a reclassification issue exists, the examiner should evaluate the taxpayer's right to relief under Section 530. Relief must be granted if the employer is eligible.

The second issue revolves around the discussion of industry practice and whether a certain percentage can be used as a "bright line" for determining what constitutes a significant segment of an industry. There is no percentage minimum that can be used for defining what constitutes a significant segment for purposes of Section 530 Relief. Neither the statute nor the legislative history impose a percentage minimum. Further, case law interpreting the term significant does not support a percentage minimum of this type.

Further details on this and other employment tax issues are available on two recently recorded IRS Technical TV Updates, "Ask the Experts: Section 530" and "Ask the Experts: Employment Tax Myths and Misconceptions." Examiners should contact local Training Coordinators to secure the videos.

If you have any questions regarding this please contact me at (202) 622-5563 or Kathy Mort, Senior Program Analyst, Office of Employment Tax Administration and Compliance at (412) 486-2917.

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